The market investigation into the supply of audit services to large companies

Submission and response to Issues Statement:

PricewaterhouseCoopers LLP

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NON-CONFIDENTIAL VERSION

Contents

This is the submission of PricewaterhouseCoopers LLP (PwC)[1], in which we set out our response to the Issues Statement published by the Competition Commission (CC) on 7 December 2011 and describe in some detail how relevant markets work.

The submission is divided into the following sections:

The following Annexes are provided in support of this submission:

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[1] References in this submission to “PwC”, “PwC UK” or “us” are to the UK firm. Where we refer to the PwC network or other firms in the international PwC network of firms we specify this.

1 Executive summary and overview

This submission responds to the Issues Statement of 7 December 2011 and sets out our observations on how the relevant markets operate - the submission is divided into seven sections which are summarised in this executive summary and overview.

In this section we explain:

A Why we have concerns about the market characteristics described in the Issues Statement

B Why we disagree with the CC's theories of harm

C The importance of quality

D Issues arising out of the banking crisis and the relationship between competition and regulation

E How the market works in practice by reference to the "four pillars" describing the key characteristics of competition in the supply of audits

We conclude that the market for statutory audit services to large companies works well and there are no features that prevent, restrict or distort competition and consequently no detrimental effects on large companies who benefit from competitively-priced and good quality audit services.

We indicate our support for a number of regulatory changes that will better equip audits to address a number of concerns, including some that arose out of the banking crisis, although we warn against other proposed changes that could have an adverse impact on competition.

1.1 In this submission, we draw in part on the rich evidence base available to us which includes client surveys and questionnaires that we have carried out over the years.[2] These are primarily conducted to enable us better to understand our clients' perception of our performance: what we do well, and how we might improve so that we can further enhance the quality of our service and more effectively compete with other audit firms. Much of this material is positive about PwC, but we learn from it whether it is positive or not. The evidence demonstrates the strong competitive pressure we face. The evidence also offers deep insights into how audit services are perceived by large companies, and we believe it will be of value to the CC in the context of this inquiry.

[2] This evidence base is described in section 2H below.

A The Issues Statement

Observations on the Issues Statement

1.2 We start with some observations on the Issues Statement.[3] We recognise that at this early stage of the inquiry the Competition Commission (CC) has limited evidence to draw on, and that much of what is available – in particular the House of Lords Economic Affairs Committee report[4], the OFT referral decision[5] and the Oxera report[6] – is lacking in any detailed analysis of the empirical evidence as to how the market works. None of this material is sufficiently reliable to enable the CC to draw any conclusions.

1.3 We understand that the Issues Statement is not a conclusion but an indication of lines of inquiry. Nevertheless, the Issues Statement does provide an initial framework for the investigation and we are therefore concerned about certain statements at the beginning of the document that seem to us to indicate substantive and procedural errors which have influenced the analysis in the remainder of the Issues Statement.

1.4 In paragraph 9 of the Issues Statement, the CC says that it has "*developed theories of harm based on an initial consideration of existing evidence*" and sets out some characteristics relating to the structure of the market and the conduct of auditors and their clients. A number of these characteristics are not contentious, although (for reasons explained below) we consider that they do not give a full picture of how the market operates.

1.5 What is contentious, however, is the statement in paragraph 10 that "*collectively, these characteristics* [i.e. those described in paragraph 9] *suggest a market with limited rivalry within it, and few external constraints*" (meaning that the suppliers have market power as is expressly stated in the first theory of harm). The Issues Statement goes on to say "*we will investigate this further and will consider whether there are any additional characteristics that may contribute to this situation*".

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3 See section 6 for our observations on market outcomes and section 7 for our more detailed response to the theories of harm set out in the Issues Statement.

4 The House of Lords report (paragraph 98 of Volume I) did not purport to reach a definitive conclusion on the relevant issues other than to recommend a detailed investigation by the OFT (which did not take place): *"A thorough review of the issues in depth and in the round is overdue. We recommend that the OFT should conduct such an investigation into the audit market in the UK, with a view to a possible referral to the Competition Commission."* See House of Lords Economic Affairs Committee 2nd Report – Auditors: Market Concentration and their role, Volume I (published 30 March 2011): http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf

5 The decision made by the Office of Fair Trading (OFT) on 21 October 2011 (the OFT Decision) to refer to the CC for investigation the supply of statutory audit services to large companies. The OFT report was prepared without the benefit of a market study and relied in large part on the House of Lords report and the Oxera report with a limited amount of additional analysis. It was unable to identify any consumer detriments other than limited choice.

6 The Oxera report (*"Competition and choice in the UK audit market"*, prepared for Department of Trade and Industry and Financial Reporting Council, April 2006) contained significant data input and methodological flaws on the key topic of the relationship between concentration and audit fees which were pointed out by PwC among others, and the OFT acknowledged and did not contradict these concerns concluding that: *"This is one area where the detailed processes and analysis of the CC could be used to determine definitively whether and if so how concentration and audit fees may be linked"* (paragraph 5.63 of the OFT Decision). Our critique of the Oxera report (which explained why it was wrong to show a relationship between market share and concentration on the one hand and prices or profits on the other) is now in the public domain: http://uk.sitestat.com/pwc/uk/s?ukws.eng_publications.pdf.pwc-competition-and-choice-in-the-uk-audit-market-a-review-of-the-oxera-report&ns_type=pdf

1.6 Paragraph 10 gives rise to two concerns: one of substance (discussed in paragraphs 1.7 and 1.8 below) and one of process (discussed in paragraph 1.9).

Substantive concern

1.7 The suggestion that the market has limited rivalry and few constraints cannot possibly follow from the characteristics described in paragraph 9 without further justification. There is no explanation as to how, in a market with at least four well-resourced, experienced and respected suppliers and sophisticated commercial purchasers (including some of the largest companies in the world), the suppliers could have market power. In the absence of collusion (which is not suggested) or tacit coordination (which, for reasons explained below, is not possible in this market)[7], we are not aware of any credible economic theory that suggests that market power is likely in such circumstances.

1.8 The misconception in paragraph 10 arises in part because the market characteristics described in paragraph 9 tell only part of the story as to how the market is structured and operates. This partial perspective is reflected in the broader narrative of the Issues Statement and the theories of harm:

(a) The four largest audit firms are described as if they are a single, undifferentiated group. There is a complete lack of recognition that each firm has its own commercial strategy and competes with the other large audit firms in the UK and, given that all four firms are members of global networks, around the world. There is overwhelming evidence of this competition between the large audit networks, some of which we present in this submission. This competitive process between the largest audit firms (and in some cases between each of the large firms and other smaller audit firms) is driven in part by the strength and bargaining power of the large companies that buy their services.

(b) While recognising the importance of an international capability to serve large companies with operations outside the UK, the Issues Statement does not acknowledge that most FTSE 350 companies - not just the largest ones - have businesses outside the UK. The resources required to develop and operate an effective audit firm network to serve these companies are not limited to physically establishing offices but require significant ongoing investment in people, methodologies and systems to ensure that the network can offer a credible, coherent, high quality and good value service. There are also significant operational costs. In addition to direct expenditure by member firms, the PwC network has an annual budget of some [✂] which enables the network to operate, including the monitoring of audit quality and the enforcement of network standards.

(c) Having made these investments, there is every incentive for an audit firm to take the benefit and spread the cost by widening its client base as much as possible - which is one reason why we (and, we believe, most if not all of our major competitors) are aggressively pursuing a growth strategy. While winning

[7] See paragraphs 7.39 - 7.42 in section 7 below.

business from companies new to the market is naturally part of such a strategy this is not sufficient and there is strong motivation to win clients, including large companies, from our competitors. An example of this is an internal programme (called "Net 635") which aims to win [✂], including some of the UK's largest companies.

(d) There is insufficient recognition that the audit firm's "client"[8] is the audited company's shareholders. It is the shareholders to whom the auditor reports by way of the public audit report included in the financial statements; it is the shareholders who appoint a company's auditor at each annual general meeting; and it is to the shareholders that the auditor owes a duty of care. On a day-to-day basis the shareholders effectively exercise scrutiny over the engagement and performance of the audit firm through the board of directors of the company and, in particular, through the audit committee as a sub-committee of the board. The audit committee has a defined, detailed and critical role in monitoring and enforcing effective audit performance and ensuring appropriate levels of independence, quality, and value. In our experience audit committees at FTSE 350 companies take their role very seriously and perform it well.

(e) We question the accuracy of the figures quoted in the Issues Statement in respect of switching[9], but in any event the references in paragraph 9 to infrequent switching and tendering are not counterbalanced by an acknowledgement of the following important facts: most negotiations of audit scope and fees take place independently of tenders; there is transparent disclosure of audit fees in company annual reports; the audit firm's service quality and value proposition are under constant review by the company as the auditor must be re-appointed annually; there are sufficient alternatives to the existing audit firm; and the companies concerned are large and sophisticated purchasers of services.

(f) The relatively small number of companies in this market, their size, their complexity and their requirement to be provided with sophisticated audit services necessarily constrain the number of suppliers that can provide such services efficiently. For large and sophisticated corporate buyers like these, the presence of at least four competing suppliers provides ample opportunity for them to exert competitive constraints on their chosen supplier. For potential suppliers, it may make no commercial sense to invest significantly to serve a relatively small number of buyers when there is already intense competition between the current suppliers, constraining available profits on entry.

(g) While there may be industry segments in the FTSE 350 in which not all of the four largest audit firms currently audit at least one large company, those firms which are relatively weak in the given segment may be perfectly capable of providing audit services to large companies in that segment. Indeed, they may currently be supplying such services to non-listed companies or non-UK

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8 In this submission we sometimes use the term "client" as shorthand for the audited company or, sometimes, in the context of the directors and management of the audited company. This should not detract from the point made in the text that the audit firm's client is, strictly, the audited company's shareholders.

9 See section 4A below.

companies in the sector, or to large companies in related sectors. It is therefore incorrect for the Issues Statement to suggest that the choice available to companies in these segments is necessarily more restricted than elsewhere in the market.[10]

(h) Arising from the failure to reflect the extent of competition between the largest audit firms there is undue emphasis placed on the ability of the mid-tier firms[11] to compete to offer the largest audits. PwC and the other large audit firms have invested over time in developing their people, systems and international networks, so as to be capable of offering the quality and value that large companies require. This reflects the business models and strategic objectives of the largest audit firms. The mid-tier accountancy firms have adopted different business models, and their levels and types of investment have reflected this. It is misconceived to assess competition as being between the largest four firms on the one hand and the mid-tier on the other and then reach the conclusion that, because the mid-tier have not made investments of the kind necessary to offer an attractive proposition to the largest companies, this demonstrates that the market is not competitive.

(i) The Issues Statement acknowledges that the largest audit firms have a strong market reputation and it is suggested in several places that this reputation may in itself be a barrier to entry or expansion. The reputation of the largest firms is built upon an underlying reality reflecting the skills, experience, global reach and other attributes that these firms have demonstrated to the market over time. Details of the attributes that are necessary to audit large companies and which have been developed by PwC and the other three largest audit firms (with varying strengths in various areas) are set out in section 3 below. To the extent that other firms are unable to offer an equivalent proposition, this is not because there is a mismatch between market perception and reality in respect of the relative skills of the largest and the mid-tier firms, but rather because the market perception does indeed reflect reality. It seems implausible to suggest that the largest and most sophisticated companies in the UK (and among the largest in the world) would systematically choose over a long period of time to purchase services from a small group of suppliers based on perceived higher quality or better value that was not borne out in fact. Indeed, it was the demands of an increasingly global and complex client base that drove the growth of the large audit firms and the establishment of global networks.[12]

Procedural concern

1.9 In addition to the substantive point above, we have a concern regarding the CC's process. The CC appears to be proceeding on the basis that the limited evidence it has reviewed to date shows that there is limited rivalry and indeed market power, and is looking for further evidence to back up this view. Paragraph 10 of the Issues

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10 See paragraphs 4.61 - 4.65 below for further detail on this point.

11 In this submission we use the same definition of mid-tier firms as in footnote 15 of the Issues Statement, that is, "*firms other than the four largest firms that carry out audits for smaller listed and unlisted companies in the UK. Some of them have clients in the FTSE 350. Examples include Grant Thornton and BDO.*"

12 See paragraph 3.9 below and Annex 4.

Statement states that: "*We will investigate this further and will consider whether there are any additional characteristics that may contribute to this situation*." We understand that the CC will wish to review any evidence that suggests limited rivalry; but equally it should be considering how far the characteristics as described, and other features not mentioned in paragraph 9, support a contrary conclusion.

1.10 We are confident that the CC will approach this investigation with an open mind and after fully considering the evidence will conclude that there is extensive rivalry between suppliers of audit services which works to the benefit of FTSE 350 companies and their owners, and in the broader interests of the UK economy.

B Theories of harm

1.11 The theories of harm described in the Issues Statement are developed from the CC's view on the market characteristics (which is why it is important that paragraph 10 and its relation to the characteristics described in paragraph 9 are subject to reconsideration to avoid distorting the analysis of the theories of harm). Our views on each of the theories of harm may be summarised as follows:[13]

(a) ***The audit market is highly concentrated and there are high barriers to entry with the result that the four largest firms have market power***

This theory is not supported by the evidence. There is strong competition between the four largest firms and there are purchasers with significant market knowledge and power. The Herfindahl-Hirschman Index (HHI) is not a helpful indicator of competitive intensity in a market such as audit services to the largest companies, but if it is applied to this market appropriately it demonstrates that the market is not highly concentrated as asserted in the Issues Statement, but in fact only moderately concentrated.[14] More importantly, this is a market with a relatively small number of purchasers where it is possible in practice to observe how the large audit firms compete so there is no need to rely on an arithmetical indicator of concentration.

The four largest firms do not have market power. Competitive tensions are demonstrated by: regular negotiations between companies and audit firms on quality and value reinforced by the threat of tendering and switching; our internal evidence which demonstrates how seriously we take that pressure; a continuous "churn" of companies into and out of the FTSE 350; movements in market shares between audit firms and M&A activity which gives rise to unpredictability. PwC internal initiatives such as "Tanks on Lawns" and "Net 635"[15] show explicitly how we target rivals' customers, and our client feedback documentation shows the intense competitive pressure we operate under. Investments and sunk costs on the part of large audit firms – driven by the competitive process – ensure that companies benefit from quality, value and efficient outcomes. The available evidence on price, profitability, quality and innovation all point to thriving

13 See section 7 below for a more detailed critique.
14 See paragraphs 6.35 - 6.39 below and Annex 9.
15 See section 4C below.

competition between the large audit networks.[16] It follows from this evidence that there is effective intra-market rivalry, which makes the existence or otherwise of barriers to entry irrelevant.

Further, there are numerous opportunities for smaller audit firms to build their businesses, including those arising from the constant "churn" of companies into and out of the FTSE 350, should they be able to demonstrate the attributes and value required by companies. Where a mid-tier firm does have the attributes to audit a FTSE 350 company, that company will have a choice between the mid-tier firm or a larger firm (as well as a choice between the largest firms) and will consider the relative skills, experience and value of each.

(b) ***The four largest firms could bundle together services in order to create barriers to entry in the market for statutory audit and in related markets***

There is no evidence of such bundling leading to a barrier to entry. The statutory audit service is commonly provided along with other audit-related services. Such audit-related services are requested by large companies from the audit firm because involving a different supplier would be extremely inefficient, given that their provision relies on the knowledge built up during the audit by the auditor. In reality they are part of the "audit service" and should not be seen as separate services. This is recognised by the regulatory framework, which defines the extent of these services and acknowledges that the threat they pose to independence is "*insignificant*" and that they therefore do not constitute a barrier to entry.[17]

Beyond these services, companies have a choice of provider for both audit and non-audit services and, in the absence of market power, there is no scope to bundle services contrary to the wishes or interests of clients. Where companies take services other than the statutory audit from an audit firm it is because the company recognises the quality and value of such additional services and, in the case of certain services, there is significant value to the company of doing so at small marginal cost. There are, in any event, regulatory restrictions on how far non-audit and audit services can be supplied by the same audit firm and we supply a smaller volume of non-audit services to our audit customers than we do to customers which we do not audit (see paragraph 4.57 below).

(c) ***Customer conduct limits competition, in particular by tendering infrequently***

This theory of harm fails to appreciate that the focus of customers is on achieving competitive outcomes. Their success in doing so demonstrates that undue emphasis should not be given to the frequency of tendering as the means of achieving such outcomes. The internal process through which large companies select and reappoint their auditor involves more scrutiny and a higher level of corporate governance than for any other business service, with an

[16] As demonstrated in section 6 below.

[17] See paragraph 7.19 below in relation to the ISA Ethical Standard on audit-related services.

annual shareholder vote required to confirm the appointment. There is transparency as to audit fees, and customers are well-informed and exert significant pressure on audit firms in respect of quality and value. This pressure is backed up by the very real threat of tendering and switching,[18] the level of which is higher than suggested by the OFT and Oxera.[19] While there are switching costs, these are not the main reason that companies do not tender – rather there are enhanced quality benefits accruing from the knowledge and experience gained over time by the existing auditor, and companies can take advantage of these benefits while the threat of tender ensures competitive pressure is placed on the audit firm.

(d) ***Specific features of the market may make it particularly prone to risks of regulatory failures which could lead to a reduction or distortion of competition in the market***

The purposes served by regulation, such as protecting auditor independence, are important to the public interest and there is no evidence of "regulatory failure" in supporting such public interest objectives. While we and other audit firms (including the mid-tier and smaller firms) seek to engage with regulators (sometimes as a group of the six largest firms) our regulators are of sufficient quality and experience to take an appropriately objective and independent view. If anything, the profile of the largest audit firms means that they are subject to stricter oversight than others, and there is clear evidence of disagreement between regulators and large audit firms on many issues. Moreover, regulation does not impose a fixed standard on audit quality, as it is the attributes and quality offered over and above the regulatory requirements and required by large companies that distinguish some audit firms from others.

(e) ***Tacit coordination between the four largest firms results in less competition in certain sectors***

There is no tacit coordination. While accepting that tacit coordination on price is less likely, the Issues Statement suggests there may be coordination on geography or industry sector. This is no more likely than price coordination and for the same reasons. In order to coordinate tacitly a firm would have to decline an invitation to tender or actively make it known that it is not interested in certain business. There is no evidence that this happens other than for good objective reasons. As described above, there is in fact overwhelming evidence of fierce competition between the large audit firms, including targeting of each other's clients, which would make any tacit coordination impossible.

In any event, market conditions are not conducive to tacit coordination:

- the structure of demand is not stable (companies move in and out of the FTSE 350 and there are changes due to M&A activity etc);
- there are strong well-informed purchasers;

[18] See section 5E below.
[19] See section 4A below.

- each large audit firm has its own commercial strategy and structure, and we (and, we believe, other large audit firms) are committed to growth which is primarily driven by winning clients from other audit firms;

- there are only a small number of sectors in which only a limited number of large audit firms are currently providing audit services to large companies, and all the largest firms are capable of making a competitive offer in all market segments;

- client relationships are long-term and high-value over the period of the relationship;

- tenders are infrequent and unpredictable as to timing;

- refusal to tender would damage an audit firm's wider relationship with a company;

- market shares are not stable and differ between large audit firms; and

- at the time of tender there is only limited predictability of audit scope over the life of the audit relationship; for example, future restructuring or mergers cannot necessarily be predicted.

(f) ***Information asymmetries and conflicts of interest adversely affect quality and allow the four largest firms to maintain market power***

There is no evidence to support this theory. It is in the interest of all stakeholders to ensure that the company's accounts are accurate and prepared to the highest standard and that the company has good audit and audit-related advice. The audit committee is an informed and responsible body and it, along with management and the board, is more than capable of assessing the quality and value of an audit and comparing one audit firm with another. In a market with well-informed and sophisticated purchasers, invariably supported by experienced accountancy and procurement professionals, purchasers would not choose to instruct a firm of lesser quality over one of higher quality simply because the former has a stronger (but apparently unmerited) reputation.

The length of time over which an audit firm audits a particular company does not undermine independence - not least because mandatory rotation of audit firm partners and staff, and regular changes in the company's management, board and audit committee personnel, mean that relationships are subject to the dynamic of constant re-assessment. In any event, no single client is of sufficient individual significance to be worth risking the reputation of any of the largest audit firms. Furthermore, the professionalism of auditors and the audit firms, rigorous internal standards, external regulatory inspection and oversight by the audit committee ensure that independence and objectivity are maintained. Institutional investors and lenders are highly sophisticated organisations who understand the importance of audit and engage with the board in order to ensure that an audit meets the assurance and governance needs of both equity and debt investors.

The risk of large audit firm failure

1.12 The Issues Statement refers to the risks that might arise in the event of a large audit firm failure or exit, while acknowledging that such events and their likely consequences are very difficult to predict. This concern stems in part from the experience of Arthur Andersen but the events surrounding the demise of Arthur Andersen should not be taken as an indicator of current risk. Changes in regulation and independent oversight since Arthur Andersen's disappearance and the heightened organisational and behavioural discipline of modern audit firms and networks reduce the likelihood of another large audit firm or network failing.

1.13 In this regard paragraph 9 of the Issues Statement states that one of the market characteristics is that *"Size has not guaranteed stability…"*, and it cites Arthur Andersen as an example of what may happen if client confidence is lost or regulators intervene. That size alone is not a "guarantee" of stability is obvious. The more pertinent point is that the largest audit firms have gained scale and other attributes in responding to market demands to provide quality audit services to the largest UK (and global) companies. These attributes (including size and diversity across different practices) are more likely to give rise to quality outcomes and increase the incentive and ability to remain independent and robust in dealing with company management where issues arise, thereby reducing the risk of failure. The global networks of large audit firms can also play an important role in assisting member firms to respond quickly and effectively to regulatory or client-related challenges by providing resources and/or expertise to help overcome such challenges.

1.14 The risk of a large audit firm failure is therefore unlikely and not sufficiently likely to constitute an adverse effect on competition. In any event, the proposal by the CC to investigate the possibility of a future failure and the demise of a large audit firm requires a forward-looking exercise more akin to that conducted in a merger inquiry than a market investigation. It would involve an assessment of counterfactuals and probabilities, seeking to predict the future actions of regulators. We have no indication as to how the CC would propose to go about this.

C Quality

1.15 It appears from the Issues Statement that the CC may have misunderstood the nature of audit services, and what this implies for quality and innovation. Whilst there is an extensive body of regulation, applying the regulations to the largest and most complex UK and global businesses is far from straightforward, and the Issues Statement is incorrect simply to state that regulation *"sets out how an audit should be conducted"*. The regulations set out principles and certain process requirements but do not provide a complete "definition" of what constitutes a high quality audit.

1.16 For example, the regulations require the auditor to exercise judgement on key aspects of an audit. Judgements are made on matters such as: the risks of material misstatement of results or financial position; the procedures needed to respond to those risks; the adequacy of a company's financial system and controls; the impact of change on the business; the reasonableness of judgements and estimates made by the business; the risk of management bias; the sufficiency and appropriateness of audit

evidence and the conclusions to be drawn from this; and the appropriate way to approach dealings and discussions with management and the board.

1.17 Whilst the Issues Statement is right to note that there is *"significant body of regulation (and architecture of regulators) intended to ensure sufficient quality"*, the competitive process is also important in stimulating high quality and innovation. Investors define what they mean by audit quality, and they demand that their auditors provide high quality, cost-effective and independent external audits. We are incentivised to provide this in order to compete to win business against high quality rivals.

1.18 An audit is not a product or commodity defined solely by standards - it is a professional service; and, as with other professional services, a quality audit service is in part differentiated by factors such as the exercise of judgement based on knowledge and experience, building and sustaining rapport, engendering trust and being skilful in influencing people, and managing an audit team efficiently, which can be very large and spread over multiple jurisdictions. We aim to distinguish our audit services in these ways through significant investment in recruitment and training of talented individuals, and supporting that talent with systems, knowledge and methodologies that help our people stand out from those working for competitors. A high quality audit for one of the UK's largest companies therefore needs to go far beyond mere compliance with published standards. It is on the basis of our people, skills and experience - which underpin the exercise of judgement and the deployment of effective "soft" skills - as well as price and value, that we differentiate ourselves.

1.19 The insight and understanding that the auditor acquires on matters such as the effectiveness of operating and financial management systems during the course of an audit can be of great value to the company and its owners. As [✂] told us: *"what I benefit from greatly is the independent view as to whether or not I am getting the right opinion or the degree to which we have internal controls in [✂] in the right place."*[20]

1.20 There are other reasons why quality is critical: it helps win and retain the best talent, which in turn ensures the audit firm's future quality; it ensures that the relevant regulatory standards are met and liability risks minimised; and a high quality audit drives high quality company reporting. The importance of ensuring quality goes beyond the interest of any one company or audit firm. It is of critical importance to capital markets and the UK economy that audits are able to provide effective assurance as to the reliability of company financial statements.

1.21 Thus, high quality results in better judgements, satisfied investors, board and audit committee and confidence in the audit firm; lower quality increases risk, decreases value and undermines the audit firm's relationship with the company thereby risking the loss of the client. This is why quality is at the heart of our business.

[20] See Exhibit 1: [✂]

D The banking crisis and regulation

Audit and the banking crisis

1.22 We understand that this CC reference is in part a consequence of the House of Lords Economic Affairs Committee Report's criticism of the role of audit firms in the lead-up to the 2008 banking crisis. The House of Lords said that first and foremost the banks themselves were to blame for the crisis and that the supervisory system was at fault but *"the complacency of bank auditors was a significant contributory factor"*.[21] However, other bodies have taken a less critical view of the role of audit firms in the crisis. The House of Commons Treasury Committee said that: *"We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient."* [22]

1.23 For our part, we do not consider that we were complacent during the banking crisis; we believe that we carried out our duties in relation to the statutory audit (as currently stipulated) appropriately and that the House of Commons Treasury Committee explicitly recognised this. In this context it is important to remember that the focus of a statutory audit is on whether the company's accounts show a true and fair view, not on ensuring that the company's business model is robust. However, we recognise that we are part of a system, alongside preparers of information, investors, analysts, regulators and other commentators, who collectively failed to pick up and address the underlying systemic risk characteristics of the crisis and that this failure calls into question the relevance of that system including the role of the audit.

1.24 What occurred in 2008 was unprecedented and cannot be allowed to happen again. There is an obligation on us, and all those involved in managing large companies and monitoring or reporting on company performance, to consider changes that might minimise the risks of such events occurring again. We have taken this obligation seriously; we have engaged with regulators, investors and companies in discussion on reforms, and we have reviewed our internal processes to consider what changes might better ensure that audit remains relevant and plays its part in a more robust regulatory framework to minimise the risk of a recurrence of the events of 2008. We have also sought to be more transparent as to the scope, processes and decision-making in an audit to help users understand its limitations as well as its uses. A more detailed description of our change agenda is set out in section 2 of this submission.[23]

1.25 There has been a tendency (of which the House of Lords report is a prominent example) to link false perceptions of statutory audit failure[24] during the financial crisis

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21 See paragraph 167 of House of Lords Economic Affairs Committee 2nd report – Auditors: Market Concentration and their role, Volume I (published 30 March 2011): http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf.

22 The report (see House of Commons Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, Ninth Report of Session 2008–09, paragraph 221) went on to make criticisms of the effectiveness of the audit system (rather than of auditors or audits) and proposed a number of changes to the system with which we do not necessarily agree.

23 See paragraph 2.59.

24 In this submission where we refer to "audit failure" we mean where a company's accounts need to be restated after an unqualified audit opinion has been given or where a company goes into a form of insolvency and the audit opinion is subsequently identified as defective.

with concerns about competition in the audit market, the presumed causality being that a lack of competitive pressure led to complacency and poor audit quality so that the possibility of failure of banks was not picked up by auditors. In fact, as set out above, the bank failures related to systemic risk which the existing regulatory and reporting frameworks did not adequately address. Therefore, whilst we strongly believe that we performed our audits in accordance with current standards and guidelines we also believe that the audit must evolve as markets become increasingly complex, the demands of stakeholders more sophisticated and new challenges arise. In this regard we are collaborating with regulators on issues such as the current eurozone crisis and the evolution of the audit in order for it to be relevant to the needs of capital markets of the future.

Regulation and competition

1.26 In the audit market, quality is an important differentiator and the competitive process drives up standards, and this is one of the reasons why audit failure is relatively rare. This is also a regulated market and competition takes place within the regulatory framework - regulation sets a floor for the standards with which auditors must comply. These standards are both ethical and technical, the former covering auditor independence and conflicts of interest.

1.27 There is no contradiction between a robust regulatory regime with strong protections for auditor independence - regulatory obligations which we regard as important and we take very seriously - and a competitive marketplace. However, in assessing how the market operates, it is important to have regard not just to the *existence* of the regulatory regime but also to the *public interest objectives* that the regime seeks to protect. This means that regulatory requirements, such as the independence rules, need to be considered not merely in respect of their competitive effects but also with regard to their public interest purposes.

1.28 In the light of the above we would ask the CC to take account of a number of related regulatory factors as it conducts its investigation:

(a) There is a danger in seeking to draw wide general conclusions about the competitiveness of audit markets from the exceptional events of 2008 which were confined to one sector, albeit a sector of critical importance to the economy and the financial system. Outside of such extraordinary circumstances, while audit failures do occur and mistakes are made, such errors are not common. That said, one error is one too many, each such mistake risks damaging the market reputation of the audit firm concerned, and we invest heavily to minimise the risk of error and the consequent impact on our reputation and competitive proposition.

(b) The discussion about competition must take into account the regulatory objectives of audit quality and independence.

(c) Possible regulatory changes, such as those currently proposed by the European Commission, need to be considered in the context of their impact on competition.[25]

E The key characteristics of competition in the supply of audits - the four pillars

1.29 We now turn to a summary of our views on competition in the provision of audit services to large companies which can be summarised in four key characteristics (which we describe as the "four pillars"):

(a) There are particular attributes required to provide large company audit services, and the four largest audit firms (and their international networks) have made the investments required to develop these attributes and hence to meet the demands of the largest companies.

(b) There is intense competition between the four large audit networks (and on occasion smaller firms), which actively target each other's customers and constantly strive to improve their services in order to gain a competitive advantage.

(c) The purchasers of these services are among the largest and most sophisticated purchasers of services in the world. They are well able to judge quality and price, and to exert "buyer pressure" on auditors both inside and outside the context of tender processes.

(d) The market demonstrates characteristics explicable only by a competitive market: prices are reasonable, profits are not excessive, and quality and innovation are high.

The first pillar: The attributes needed to audit large companies

1.30 As companies have become larger, more global and complex, so it has been necessary for the audit firms which wish to supply audits to them to grow, to develop international networks, and to implement global standards, methodologies and systems to meet the companies' requirements. The evolution of PwC (and the other large audit networks) was a response to evolving demand for complex and global audit services:

(a) We have developed to meet these demands in terms of people and performance, specialist and industry expertise, international coverage, audit methodology and compliance systems. We are part of an international network of firms with offices in 771 locations across 158 countries, with almost 169,000 employees, and with a gross turnover of US$29.2 billion in the year ending 30 June 2011. As of December 2011, the UK firm had 862 partners and a permanent headcount of 15,862. We make significant investments to be able to meet the requirements of large companies, for example, in the UK we spent [✂] million on staff development in 2010 and contributed [✂] million in the course of

[25] See section 2G below.

the last three years to a global network investment of some US$400 million in bespoke audit support IT software.

(b) A range of specialists are involved in the audit, such as controls assurance experts (who evaluate IT systems and controls), accounting technical specialists and other practice specialists (such as tax, treasury and valuation experts) who support the audit practice as required in addition to delivering their own standalone advisory assignments.

(c) These attributes are required and valued by companies throughout the FTSE 350, not only those at the very top of the FTSE 100, and this is demonstrated by comments from clients.[26]

(d) It is the possession of these necessary attributes that distinguishes the largest firms from the mid-tier firms, and it is upon these attributes that the reputations of the largest firms are built. For example, one of our client feedback reports recorded that the chair of the [✂] audit committee told us that "*the firms below the Big Four were in her words 'miles away' in terms of level of service.*"[27] This does not mean that the mid-tier are not good at what they do but rather that they have a different business model from those of the largest audit firms and they have not invested to the same degree in the attributes required to meet the needs of the largest companies.

The second pillar: There is competition between the large audit firms

1.31 In a market that includes the largest and most sophisticated companies in the UK, the presence of four main suppliers ensures that the market is fully competitive. There is fierce competition and differentiation between the four largest audit firms:

(a) The market is much more fluid than suggested by the OFT. Only 55 of our 108 FTSE 350 clients in Q3 2011 (that is, around half) were in the index and audited by us in Q2 2001. 114 companies audited by us exited the FTSE 350 in the last ten years and 94 companies audited by us entered over the same period (not including firms that have made multiple entries and exits). In addition we lost the equivalent of 19% of our total Q2 2001 client base within the FTSE 350 as a result of switches to other firms over that ten year period while gaining the equivalent of 25% of our Q3 2011 client base through switches to us within the FTSE 350 over the same period. Other large audit firms have faced similar rates of "churn", with Deloitte doubling its market share (from 45 to 89 FTSE 350 clients) within that period (significantly higher than may be attributed to its acquisition of Arthur Andersen). Indeed the constant "churn" in membership of the FTSE 350 creates numerous entry opportunities for smaller firms if they can show growing companies which have been their clients that they have the necessary attributes to retain the audits as the companies grow.

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26 See section 3 for further detail.

27 See Exhibit 2: [✂]

(b) We invest significant resources and efforts in seeking to differentiate our services from strong rivals in order to win and retain clients in the face of competitive challenges from other audit firms.

(c) We have ambitions to expand our audit practice, and we actively target the audit clients of our competitors. This sometimes involves establishing a dedicated "shadow team" to build up relationships with the key stakeholders within the identified target company. Under the "Net 635" programme we are seeking to win [✂]. This includes winning FTSE 100 companies from our competitors and further active targets among smaller FTSE 350 companies. Our significant wins in 2011 included Aviva from Ernst & Young, TUI Travel from KPMG and IG Group from Ernst & Young.

(d) But equally we are aware of attempts by competitors to target our clients, including through setting up their own teams to shadow our audit teams – [✂] for example, while in recent years we have been told by [✂] that "*all 4 firms are 'at the door' with their best advisers*"[28] and by the [✂] that *"[✂] are active in trying to position themselves should [a tender] happen."*[29] We lost [✂] in 2009 because of a tender triggered by [✂] targeting the client and a further recent example of competitor targeting has been our having had to respond to [✂].

(e) Independence restrictions which limit certain non-audit work that may be carried out by audit firms for audit clients in our view get the balance about right between, on the one hand, demonstrating that auditors are independent, while, on the other hand, ensuring that clients who require non-audit services have an effective choice of provider (which includes audit firms and non-audit consultants). The current regime also ensures that audit teams can draw on non-audit specialists in support of audit quality. Tighter (or more relaxed) restrictions risk upsetting this balance.

(f) Strong industry expertise is welcomed by clients and enables the audit firm to offer high quality focused audit services. We compete in all industry sectors and we are not aware of any sector in which companies have no choice of audit service provider. Neither are we aware of a sector in which all four of the large audit firms could not offer a competitive service if opportunities should arise. In any sector where any one of the four largest firms is perceived to be relatively weak, that firm should have the capabilities to offer a competitive service drawing on: its general large company audit experience; network familiarity with the sector outside the UK; and UK experience auditing both non-listed UK companies and overseas listed companies in the same sector. For example, although Ernst & Young does not currently audit any of the listed high street banks, it does have experience of auditing the UK operations of banks listed in other countries; it audits specialist UK banks such as Investec (which is FTSE 100 listed); and it could bring in senior audit partners from other jurisdictions, or hire from competitors, if it considered there to be a market opportunity.

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28 See Exhibit 3: [✂]

29 See Exhibit 4: [✂]

(g) An audit firm would not be in breach of its ethical or regulatory obligations in auditing several competing companies. Although some companies may not wish to select an audit firm which audits a competitor, that is purely a matter of client choice. For example, we audit Tesco, J Sainsbury and Waitrose, as well as companies which supply these supermarkets.

The third pillar: Large companies are effective purchasers

1.32 Large companies within the FTSE 350 and which may enter it are extremely effective purchasers of audit services, well able to ensure that there is intense competition to supply their audits:

(a) Audit is a business-to-business market in which the potential suppliers are well known to the purchasers and there is significant formal and informal information available to companies about the performance of the audit firms. Formal data includes the published material of the Audit Inspection Unit and company published accounts which set out details of audit and other fees. Informal information is available through the network of finance directors, board members and audit committee members who regularly move between companies (or have board roles in several companies simultaneously) and are able to judge the performance of auditors and their value proposition through first-hand experience, sometimes relying on advice from procurement professionals. For example, feedback on [✂] warned: *"be alert to re-tender risk…there is no appetite currently but [✂] is on several boards where he can benchmark us against other firms…Fan of a 'fresh pair of eyes'".*[30]

(b) There is an ever-present threat to the audit firm that the audit will be put out to tender. There are a sufficient number of tenders (on average about 13 to 14 a year in the FTSE 350) to make this threat a reality. To respond to any tender will require the audit firm to commit substantial time and resources, which will inevitably involve business disruption. Furthermore, if the tender is conducted because of dissatisfaction, it is often the case that the existing audit firm will lose the business. Given that there are material costs for the company involved in tendering and that the company is unlikely to put the business out to tender again for several years (unless the audit firm's performance is unsatisfactory), there is much for an audit firm to lose (and to gain) when an audit contract is tendered.

(c) The threat of tendering and switching is therefore very real, and this gives the company considerable bargaining power which enables it to exert pressure on the audit firm in respect of quality and value without going to the expense of tendering. Internal client reports contain numerous examples of companies putting fee pressure on us. For example, [✂] said *"We think you're great…but where we're likely to fall out is over the fee"*.[31] This pressure is even greater at times of economic difficulty. [✂] explained: *"We're expected by our customers*

[30] See Exhibit 5: [✂]
[31] See Exhibit 6: [✂]

to reduce our costs every year…so then really, really, really we ought to expect that of our suppliers".[32]

(d) There are regular opportunities for the company to exercise this pressure. The audit appointment is renewed annually by shareholder vote, which is generally preceded by an auditor effectiveness review overseen by the audit committee; there is a detailed annual negotiation on audit scope and fees; lead audit partner rotation is mandatory every five years, and in our experience companies often take this opportunity for a more detailed review of performance and terms; key new personnel (such as the finance director) who join the company have expectations from their previous employment and assess the audit firm against that of their previous employer; mergers and acquisitions (which are quite frequent among the FTSE 350) may result in a review of audit firms, particularly if the merging companies use different audit firms; and there are pressures from investors on companies to demonstrate that they are meeting the highest corporate governance standards by ensuring that the audit supplier is offering an appropriate and good value service.

(e) Given the sophistication and experience of the individuals within the large company responsible for recommending the appointment of the auditor (being principally the members of the audit committee and the finance director) companies are well capable of exercising effectively their discretion in choosing when and how best to test their existing audit firm against the market.

1.33 There are strong incentives to negotiate competitive terms of supply absent very frequent tendering. In particular:

(a) The tender process gives rise to costs and risks to both parties:

(i) for the company, these are tender costs, the costs of getting the new audit firm up to speed and increased risk of audit failure in the early years; and

(ii) for the current audit firm, these are tender costs and, if the appointment is lost - as is often the case following a tender where the client is dissatisfied - loss of profits, loss of the client's contribution to common costs, and reputational impact.

(b) The company, as an informed purchaser, does not need a tender process to monitor and compare its current audit firm's quality, price and value with the quality, price and value of other audit firms.

(c) The risk of a tender (and consequent loss of the appointment) are sufficiently great that the current audit firm has a strong incentive to negotiate seriously and agree competitive terms.

1.34 So, frequent tenders are not necessary in order to ensure that good quality audits are provided at a fair price. Indeed frequent tenders would be inefficient - adding to costs and risks with no material benefit and potentially reducing quality (through the learning

[32] See Exhibit 7: [✂]

curve effect and the lack of incentive for either party to invest in ensuring the auditor knows the audited business and people well). This is why tenders in audit markets are not as frequent as in some other markets, but when they do occur, particularly if prompted by dissatisfaction, the current auditor often loses – a salutary warning to audit firms of the risks of failing to meet the price and quality requirements of their current clients.

The fourth pillar: The market operates efficiently and there are no adverse outcomes

1.35 There are no detrimental market outcomes:

(a) Although it is difficult to compare prices over time because there may be changes in audit scope brought about by regulation, company structural changes and mergers, our average hourly rate realised from clients for audit services has not increased in even nominal terms in the last four years - and has therefore fallen in real terms. There are regular (usually annual) discussions between companies and auditors on quality, price, and value. We continuously work to improve our operating efficiency, driven by the need to remain competitive and the interests of our partners. In a partnership, where the owners are also the managers, there is every opportunity and incentive to identify and eliminate inefficiencies and focus on bottom line profitability.

(b) Neither is there any indication that profits are excessive. Our FY11 audit operating profit margin is 14% (and has been around 18% on average over the last three years), as disclosed in our published Transparency Report figures. Even on the basis of a simplistic comparison, this is below the average FY11 profit margin of companies in the FTSE All Share Index (of 23%).[33]

(c) Buyer pressure results in quality being one of the primary drivers of competition between audit firms causing us to make substantial investments to ensure that quality is of a high standard, while continuing to refine our methodology to remain competitive on cost. While there have been examples of audits not picking up matters that should have been identified, these are rare, and some cases that are attributed to audit failure are in fact due to other causes.

(d) PwC and other major accountancy firms face significant competition in the supply of non-audit services, not only from each other but also from the mid-tier firms, law firms and other professional service businesses such as management consultancies. The relative proportion of non-audit services provided to large company audit clients has declined in recent years. In 2006, non-audit services provided to audit clients accounted for 23% of our turnover, but this has fallen to 16% in 2011, while non-audit services provided to non-audit clients have increased from 49% to 58% in the same period. This is a result of a combination

[33] See paragraphs 6.17 - 6.19 below. We do not believe such simplistic comparisons are like-for-like, since FTSE companies pay their executives a salary, which is reflected in their operating costs, while PwC is structured as a limited liability partnership (LLP) and no partner salary costs are captured in operating costs. By excluding any costs related to our UK partners, we significantly overstate our operating margin in comparison with FTSE companies.

of increased competition as well as regulatory and governance changes which have reduced companies' willingness or ability to use their auditor for non-audit services.

1.36 As we have explained, significant investments are required for an audit firm to be in a position to provide a quality audit service of the kind required by investors of large companies and regulators. Given the relatively limited number of companies which require such services, there is clearly a constraint on the number of audit firms making such investments that the market can efficiently support, beyond which inefficiencies would start to arise leading to rising audit costs and/or reductions in investment and quality. It is for the market to determine such level and under the current market structure there is strong competition between the largest firms as each seeks to maximise its return from its past and continuing investments and to offer a more attractive competitive proposition than its rival audit firms. In short, the current market structure reflects a competitive outcome and a continuing competitive process in which audit firms have to make decisions on investment based on customer requirements for quality and value, and the likely returns from meeting those demands.

Conclusion

1.37 It is apparent from the above that the market for statutory audit services to large companies works well and there are no features that prevent, restrict or distort competition. Four large audit firms strongly compete and, as part of this competitive process and to reflect regulatory objectives and market demands, have invested (and continue to invest) in people, systems, methodologies and a global network to ensure that purchasers receive high quality and good value services and that the public interest in effective UK capital markets is properly protected.

1.38 The evidence shows that there are no detrimental effects on large companies (the consumers of our audit services) as a result of any failing of competition in the audit market, and they benefit from higher quality and lower prices than would be the case under any conceivable alternative regime that served similar public interest objectives. This is demonstrated by quality outcomes and profitability at competitive levels.

1.39 We recognise the need for certain enhancements to be made to the audit process to ensure that it best fulfils the needs of shareholders, companies, the broader investor community and the wider public interest, and we have publicly stated our support for such changes.[34] However, these interventions are not required to address a lack of competition, and some of the regulatory proposals being considered (in particular a number put forward by the European Commission) could have profoundly detrimental implications for competition in the markets for audit and non-audit services in the UK and elsewhere (we summarise our views on these matters in section 3D). Accordingly, we would ask the CC to consider these proposals and their likely impact in the course of this inquiry.

[34] See section 2G below.

2 Background on PwC and audits

In this section we set out some issues and themes that are key to an understanding of PwC's audit business and the operation of the audit market. It is impossible to assess how competition works without an appreciation of the nature of audit services. This section covers:

A An overview of PwC

B The role of the audit and what auditors do

C The importance of breadth of capability and professional judgement in the audit process

D The commercial value of an audit

E The importance of quality and how it is assessed

F The relationship between the audit firm and the company

G The regulatory landscape

H The nature of the evidence to support the four pillars of how the market operates

A An overview of PwC

2.1 An overview of our business structure and high level business objectives is set out in Annex 1, but in brief:

(a) We are a limited liability partnership incorporated in England and Wales and wholly owned by our members (partners).

(b) We are a member firm of the PwC international network through membership of PricewaterhouseCoopers International Limited, a UK company limited by guarantee. As at 30 June 2011, the network operates in 158 countries and in 771 locations.[35]

(c) Our objective is to build long-term relationships with our clients and invest in delivering high quality services that will help us create value for their businesses. We go to market by industry and region, deploying multi-disciplinary teams as required. We are managed through three principal Lines of Service (LoS): Assurance, Advisory and Tax. The audit business sits within Assurance, but partners and staff from the other LoS contribute to audit services.

[35] See PwC Global Annual Review 2011 available at www.pwc.com/annualreview.

(d) The Assurance LoS has four businesses: Core Assurance (which primarily provides statutory audit services); Risk Assurance; Actuarial and Insurance Management Services; and Capital Markets and Structuring. Core Assurance and Risk Assurance, which provide statutory audit and other assurance services, are organised in ten business units. The business units in London consist of Top Tier, Mid Tier, Banking and Capital Markets, and Insurance and Investment Management, plus six business units in the regions.

(e) We are led by an Executive Board (which includes the LoS leaders and is chaired by an elected Senior Partner). There is also a Supervisory Board which is elected by the partners to provide oversight and a Public Interest Body (PIB) which includes independent non-executives.

2.2 Although the business is, for management purposes, divided into the three LoS, PwC is a single cohesive partnership in which the whole is more than the sum of its parts. This means that each LoS and each partner contributes not just through their own products and competencies, but to building the overall business and the quality of our offering across the range of our businesses. We recognise that we face strong competition in all of our business areas, and if we are able to supply a quality offering in one business area and show that we understand and can add value to the company's business, there is a better chance that the company will consider us when they require advice in other areas.

B The role of the audit and what auditors do - the statutory and regulatory framework

The role of audit and the duty of the auditors

2.3 The relevant service for the purposes of this inquiry is "*an audit conducted by a person appointed as auditor under Part 16 of the Companies Act 2006*".

2.4 There is an obligation on directors under the Companies Act 2006 (section 380 onwards) and, for listed companies under European Union IAS Regulations (1606/2002), to prepare company accounts and, where the company is a parent company, to prepare group (consolidated) financial statements.

2.5 Since the middle of the nineteenth century the statutory audit has played a critical role in providing assurance to shareholders that the directors have presented a reliable, robust and objective view of the company's financial position. As such, an audit underpins the trust and obligation of stewardship between those who manage a company and those who own or invest in it. It allows the separation of the provision of capital from the running of a business, without which market economies could not function well.

2.6 The auditor's obligation is to state whether, in his or her opinion, the annual accounts give a *"true and fair"* view[36]; and also that they have been properly prepared in accordance with the relevant financial reporting framework, the requirements of the

[36] Companies Act 2006, section 495.

Companies Act 2006 and, where applicable, Article 4 of the IAS Regulations. We discuss other reporting requirements below.

2.7 The group auditor is responsible for the audit of the group accounts as a whole. Therefore, for large, internationally diverse UK listed businesses, the lead audit partner and his or her team in the UK need to understand and respond to business issues and developments around the world. Whilst global investments in common methodologies and systems are necessary to provide audit services to such businesses, to be fully effective the UK lead audit partners typically need to visit overseas locations and interact effectively with overseas management and audit teams, an exercise which requires careful and extensive planning and coordination as well as a sensitivity to different cultures and an awareness of local ethical rules.

2.8 An audit is a rigorous evidence gathering and analytical investigation leading to the publication of an auditor's report on the financial statements which is formally addressed to the company's members (shareholders), but which is often of great value to other parties, most notably other investors such as banks. The auditor's report can be modified or unmodified and must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.[37] There are other matters which need to be covered in the audit report - for example, whether the directors' report is consistent with the annual accounts[38], and issues relating to directors' remuneration[39] and corporate governance (in respect of publicly traded companies).[40]

2.9 The auditor is also required to form an opinion, as part of an audit and in preparing the report, on matters such as the adequacy of accounting records that have been kept by the company and whether the company's individual accounts are in agreement with the accounting records and returns, and to report by exception in those circumstances when, in the auditor's opinion, those requirements have not been satisfied.[41] The auditor has extensive powers in carrying out his or her duties including a right of access at all times to the company's books, accounts and vouchers and may require the provision of information from a range of parties including the company's officers and employees[42] and including information from overseas entities.[43] It is a criminal offence knowingly or recklessly to cause an auditor's report to include any matter that is misleading, false or deceptive in a material particular.[44] The audit report must be signed by the individual auditor in his or her own name.

The audit committee

2.10 Under the UK Corporate Governance Code (2010) (the Code), the board of a company should establish formal and transparent arrangements for considering how they should

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37 Ibid, section 495(4) and further guidance is provided to auditors in ISAs (UK & Ireland) 700 *"The auditor's report on financial statements"* and 705 *"Modifications to the opinion in the independent auditors report"* and 706 *"Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report"*.

38 Ibid, section 496.

39 Ibid, section 497.

40 Ibid, section 497A.

41 Ibid, section 498.

42 Ibid, section 499.

43 Ibid, section 500.

44 Ibid, section 507.

apply corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors.[45] This is primarily performed through the establishment of an "audit committee" which should comprise at least three (or in the case of smaller companies two) members who are independent non-executive directors, at least one of whom has recent and relevant financial experience.[46] The board is of course ultimately acting on behalf of, and responsible to, the shareholders and is subject to re-election every year.

2.11 The audit committee is responsible for, among other things, monitoring the integrity of the company's financial statements and reviewing significant financial reporting judgements contained in them. The audit committee must review the audit findings with the audit firm including resolved and unresolved major issues, key accounting and audit judgements and errors identified during the audit. The audit committee is required to communicate in a timely manner to the relevant parties about audit matters, including: issues arising from the audit of financial statements; auditor independence; the engagement terms; audit planning and scope and audit findings.[47]

2.12 The company is also required in its annual report to disclose both the audit fee and all other fees paid to the auditor for audit-related and non-audit work during the preceding financial year.

The regulatory framework

2.13 There is a significant regulatory structure put in place to implement the statutory requirements. Reference to "regulatory structure" is used here in the context of regulation of both corporate financial reporting and regulation of audits and audit firms. In the UK the regulations are set and enforced by the Financial Reporting Council (FRC). The standards to be applied in conducting an audit are set out in the International Standards on Auditing (UK and Ireland) (ISAs (UK and I)) which are mandatory for all UK audits. UK audit firms also have to comply with the requirements of the International Standard on Quality Control (UK & Ireland) (ISQC (UK & I)).[48]

2.14 These standards cover matters such as client and engagement acceptance, agreeing the terms of an audit engagement, quality control, audit documentation, and communications of audit matters with those charged with governance. Ethical standards for auditors established by the Auditing Practices Board (APB) (which is overseen by the FRC) cover issues such as auditor integrity, objectivity and independence, and include obligations for mandatory five-yearly rotation of lead audit partners on each listed company audit and some restrictions on the provision of non-audit services. These requirements reflect in part obligations under applicable EU directives. Financial statement reporting requirements for companies are set out in the Companies Act 2006 and applicable accounting standards. International Financial Reporting Standards (IFRS) must be followed for consolidated accounts of listed

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45 The Code, Main principle C.3.

46 If no audit committee is formed, the company should explain why not in its annual report. UK Corporate Governance Code (FRC).

47 ISA (UK & Ireland) 260 (APB 2004b).

48 ISQC (UK&I) 1 (revised). *"Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Service Engagements"*. Published 15 October 2009.

companies together with UK Listing Authority Rules and UK Corporate Governance Code provisions.

2.15 The critical purpose of the regulatory framework is to ensure that audits achieve their public interest objective of reporting on the accuracy of companies' financial statements. The public investment in the regulatory framework reflects the importance of this objective and the need to ensure that public interest objectives are seen to be protected. Auditors of course have a key role in contributing to the regulatory debate, and it is necessary that former auditors have roles within these regulatory bodies in order to impart appropriate expertise. However, contrary to the suggestion in the Issues Statement,[49] there is no evidence of auditors being able to influence regulation to their own advantage, and this would be contrary to the entire purpose of the extensive regulatory framework that has been established.

2.16 A more detailed description of the evolution of the regulatory regime, accounting and auditing standards, together with the practicalities of carrying out an audit, is set out in Annex 2. This provides the overall framework within which an audit is conducted.

C The importance of breadth of capability and professional judgement in the audit process

2.17 In seeking to achieve the objectives of a statutory audit, as outlined above, it is necessary for an audit firm to possess two key characteristics: (a) depth and breadth of capability available to conduct an audit within often tight deadlines; and (b) high quality individuals able to exercise professional judgement effectively on a number of matters.

Depth and breadth of capability

2.18 An auditor is required to give an opinion concerning the fair presentation of both the financial statements of the company and the consolidated financial statements of the group – that is, whether or not they present a true and fair view. In order to form this opinion it is necessary for the audit team to undertake audit procedures, which will include inspection of documents and records, physical inspection of assets and discussions with relevant individuals at the company and across the wider group. The objectives and requirements that an auditor must comply with in performing an audit are set out in the ISAs (UK and Ireland). These are the same for all audits. However, the nature and extent of evidence gathering, follow-up investigations and analysis that the audit team performs to satisfy these requirements is dependent on a number of factors including: the size of the group; the number of locations and territories in which the group operates; the complexity of the business and industry; and the specific circumstances of the relevant group, including how it is financed and what systems it operates. This in turn determines the amount and breadth of resources needed to conduct those evidence gathering investigations and analysis, including the need to involve specialists and experts, and audit teams in overseas territories.

[49] Issues Statement, paragraph 43.

2.19 The attributes that we (and to varying degrees the other largest audit firms) have developed to ensure that we are capable of auditing the largest companies are set out in detail in section 3 below, together with illustrative examples of what is involved in practice to audit [✂] (as an illustrative FTSE 100 company) and [✂] (as an illustrative FTSE 250 company).

2.20 As section 3 below demonstrates, the breadth of capabilities needed to provide effective audits to most of the UK's largest listed companies is currently present in the four largest audit firms. This has been recognised, for example by the Competition Directorate of the European Commission[50] and by the OFT[51]. This has led to unhelpful confusion over whether, of and by itself, audit firm size is a necessary attribute to audit a large company. In our view, size is an outcome of developing the capabilities to meet large company needs, rather than a necessary attribute in its own right. In order to provide the full breadth of capabilities that are required to audit a large company, an audit firm naturally becomes larger as it employs more people and diversifies into different disciplines, and it is only economic to make the large investments (which include contributing to global network costs) when the firm is sufficiently large to be able to raise the necessary capital and spread its costs across a minimum number of audits. Having made the necessary investments, an audit firm is better placed to retain and win new business, leading to an increase in size.

2.21 There are three principal aspects where size itself may be important:

(a) first, it reduces the significance of any individual audit appointment to the audit firm, lessening any possible concern about compromised independence where an audit fee is considered material to the auditor;

(b) second, it increases the financial resources available to the audit firm when exposing itself to the liability risk associated with a large audit appointment; and

(c) third, it enables the auditor to make investments to carry out the audit as efficiently and effectively as possible.

Professional judgement

2.22 The breadth of capabilities required is only one element in the mix. The statutory language of "opinion" and "true and fair" shows that professional judgement is involved in delivering audit services, and an audit of a smaller company may give rise to issues of professional judgement for the audit team that are of equal or more difficulty than those in a large company audit. For example, smaller companies can go through restructurings, face difficult impairment judgements, change their accounting systems and have complex tax or litigation liabilities.

2.23 Whether the company is relatively large or small (all FTSE 350 companies are large by the standards of UK businesses generally) the conduct of an audit is governed by the statutory and regulatory obligations and, to fulfil those obligations, the audit team is

[50] European Commission Decision in Case No COMP/M.2810 - *Deloitte & Touche / Andersen (UK)*, paragraph 24.

[51] OFT Decision, paragraph 5.34.

required to exercise professional judgement in a number of ways. These can be broadly categorised as follows:

(a) Judgements about risks of material misstatement and the nature and extent of the procedures needed to respond to those risks, such that an audit plan is comprehensive and appropriate for the company in question. This category includes assessing the impact of changes in the business, the reliability of systems and controls, and the likelihood of fraud.

(b) Judgements about the reasonableness of approaches taken and estimates made by management in preparing the financial statements:

(i) A wide range of questions arise in this respect, including: the appropriateness of accounting policies; the presentation and disclosure of exceptional items (for example following corporate restructurings); the measurement of intangible assets; the treatment of business acquisitions; the valuation of inventories; the measurement and recognition of deferred tax assets and liabilities; the provisions for litigation risks; the valuation and recognition of share based payments; and the appropriate presentation of the financial statements in accordance with the applicable financial reporting framework.

(ii) Whether there are material uncertainties affecting the directors' statement that the company is a going concern (i.e. that the company will continue in business for the foreseeable future and that the assets of the company will be realised and the liabilities will be settled in the normal course of the company's business). At the current time of global financial turmoil, this can be a particularly difficult judgement to make in a fast changing environment, where assumptions considered reasonable at a specific point in time can quickly appear unreasonable.

(c) Judgements about the sufficiency and appropriateness of audit evidence obtained, drawing conclusions from this, and determining how to respond to identified issues. For example, while there are a number of documents and records that need to be reviewed in any audit, the decision whether to require further information or conduct additional audit procedures to obtain further evidence needs the exercise of professional judgement, as do decisions about whether changes to the draft financial statements are necessary (so as to avoid a qualified audit opinion) in the light of the information gathered by the audit team. This will involve an assessment as to the materiality of the matter and the audit team's assessment of the impact on the truth and fairness of the financial statements if that item were not to be adjusted.

(d) The audit team also exercises professional judgement in determining the most appropriate way to approach dealings and discussions with the audit committee, management and the board. The audit process inevitably involves extensive discussion between the audit firm and employees and officers of the company at various levels of seniority. It is clearly important that information is extracted, and discussions on matters where there may be disagreement should be

conducted, in as effective a manner as possible so that the auditor can get to the bottom of possible concerns without unduly disrupting the business of the company. A good auditor will approach the right level of management in respect of any particular issue, know when to escalate this to more senior management or the audit committee, and carry authority and credibility in those discussions. The auditor will report to the board and the audit committee on the issues of concern or interest and may have separate meetings with non-executive directors, such as the audit committee chair. He or she will need to identify the issues that are likely to merit such reporting and the most effective means of communicating them.

(e) Managing the audit team can itself be a very significant undertaking which requires the exercise of judgement in making best use of resources and coordinating the team effort. A large audit can involve up to 100 or more partners and 500 or more other staff, including specialists drawn from PwC network firms, in multiple locations around the world. Sophisticated systems, methodologies and training are required to ensure consistency, avoid duplication and bring about a coherent audit report in what may be a rapidly changing business and organisational environment. Given that different parts of the company will be operating in different regulatory, competitive and economic environments, which could change at different times, managing a global audit is a major logistical exercise.

2.24 An illustration which shows that the ability of a good auditor to demonstrate sound professional judgement is required – and indeed valued – by large companies comes from [✂], which recorded: "*Key strengths are the people, the independence of mind when it comes to really difficult decisions, the depth of the audit team and the global reach.*"[52] This comment also indicates the importance attached to the size and scope of the audit team and, in particular, the key partners who embody the expertise and experience of PwC.

D The commercial value of an audit

2.25 In the following paragraphs we describe first the value of an audit to capital markets generally and second the value to the company.

The value to capital markets

2.26 Although attempting to quantify the value of an audit is difficult, the absence of a credible audit would inevitably reduce the faith of investors (shareholders and lenders) in a company's financial statements, and consequently would reduce investors' willingness to provide equity or debt to that company. This would directly increase the effective cost of capital facing the company, reflecting the higher level of risk to which investors would perceive themselves exposed. In the context of the largest, most complex global companies – such as many of those listed in the FTSE 350 – this uncertainty would be greater, and the consequent increase in the effective cost of capital also greater, outweighing by an order of magnitude the cost of a credible audit.

[52] See Exhibit 8: [✂]

The value to the company

2.27 The purpose of the audit is to put the auditor in a position to refer pertinent matters to those directors and officials at the company charged with governance, form an opinion on the financial statements and issue an audit report to the shareholders. In addition, in the course of conducting the audit the auditor gains an understanding of the company and its systems which enables a good auditor to provide insights which are of great value to the company beyond the immediate purpose of the audit report. This may include commenting on the effectiveness of the audited company's operating and financial management systems, sometimes benchmarked against other businesses; evaluating the design and implementation of the company's system of internal controls; and, where appropriate, making recommendations for improvement. A written report will be provided to the audit committee summarising the outcomes of the audit and will normally contain recommendations for improvement in controls and reporting practices. Management and hence shareholders, through improved business performance, benefit from these insights.

2.28 Feedback from our clients demonstrates the value that companies seek, and (we hope) receive, from us as their auditors:

(a) [✂]: *"We get quite a lot of value out of [the lead partner's] comments at Audit Committee meetings both at a PLC and a regional Audit Committee; I use him as a sounding board […] I place equal value, if not more, on some of the more informal feedback."*[53]

(b) [✂]: *"What I benefit from greatly is the independent view as to whether or not I am getting the right opinion or the degree to which we have internal controls in [✂] in the right place."*[54]

(c) [✂]: *"What I want them to do is basically critique my view with all the experience they can bring to bear."*[55]

2.29 Ensuring that we offer large companies insights and advice on controls, benchmarking and industry best practice (as well as more general updates on legal and regulatory developments) is an intrinsic part of the audit service demanded by our larger audit clients. Although some of these outputs are not strictly part of the audit they utilise information and experience gained by the auditor during the audit and at very low incremental cost they can add substantial incremental value to the company. This is encapsulated by the comment from [✂], where they told us that reviews and analysis applicable to the business and industry are "*absolutely worth their weight in gold.*"[56]

2.30 Failure to deliver high quality auditing value of this nature would result in us losing audit business[57] and the need to ensure effective delivery is a driver of our "Value without

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53 See Exhibit 9: [✂]
54 See Exhibit 1: [✂]
55 See Exhibit 10: [✂]
56 See Exhibit 11: [✂]
57 This is just one aspect of the service on which the large audit firms compete, and there are many examples of rivals approaching clients with ideas and suggestions of how they would be able to offer superior value - see paragraphs 4.41 - 4.43 below.

Compromise" initiative and the PwC Experience initiative (both described in Annex 6). The value of such advice is illustrated by some other of our Client Perspective Reports (CPRs):

(a) [✂]: *"[✂] is a young company and PwC needs to match its dynamism. Feedback, insights, provocation and challenge need to become an integral part of the service."*[58]

(b) [✂]: *"As a company, [✂] has come a long way over recent years and as a strong FTSE 250 client, is keen to operate best practice. Therefore in light of the level of exposure that the [PwC] team has with other clients, any benchmarking or support to ensure [✂] is well-run would be valued."*[59]

(c) [✂]: *"Added value for me is simple conversations around risk, control; all those things that a CEO and FD take for granted."*[60]

2.31 An audit therefore requires the auditor to exercise judgement and discretion and provide insight. If this is done well, the cost to the company is reduced (because unnecessary costs and procedures are avoided); the reliability of the company's accounts and audit is enhanced (because risks are identified earlier and there is a lower likelihood of error, although the risk of error can never be entirely eliminated); and the added value to the company can be significant (because information gathered during the audit will be effectively utilised). If on the other hand the audit is conducted inefficiently or the audit firm is not properly experienced, this results in increased costs to the company, a less reliable report and a failure to derive wider benefit from the audit process.

E The importance of quality and how it is assessed

2.32 In the following paragraphs we explain why quality matters and how it is assessed.

Why quality matters

2.33 A combination of strong competitive pressure, coupled with stringent regulatory requirements, motivates us to provide our clients with service at the highest reasonable level of quality. This is something which is imbued in our culture and reinforced regularly by senior management, and it is also recognised by the Audit Inspection Unit (AIU) in its latest public report on PwC, for example:

(a) Ian Powell (PwC Chairman and Senior Partner) stated in PwC's 2011 Annual Report: *"Our reputation is built on audit quality and we continue to invest heavily in this core part of our business to make sure we have the right people and systems in place".*[61]

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58 See Exhibit 12: [✂]
59 See Exhibit 13: [✂]
60 See Exhibit 14: [✂]
61 See Exhibit 15: Building for the future, Annual Report 2011, page 5. Our commitment to quality is also expressed in our latest business plan, see Exhibit 16: FY12 and Beyond - Smarter growth. Quality is set out as a performance goal in recognition of its importance to the firm, our clients, investors and regulators.

(b) Richard Sexton (Executive Board member, Reputation and Regulatory Policy) explains in PwC's latest Transparency Report: *"audit quality remains of paramount importance to us and we continue to focus on quality in its widest sense and not simply to meet specific regulatory requirements."*[62]

(c) The AIU public report into PwC 2011 states: *"Tone at the top - focus on audit quality, growth and efficiency: The leadership of the firm and audit practice continue to focus on achieving efficiencies on audits and growing the business and aiming to maintain or improve audit quality. While there was no evidence in the sample of audits we reviewed that the focus on growth and efficiency adversely affected audit quality, continued care is needed to ensure this remains the case in the future."*[63]

2.34 Quality is important to us for the following reasons:

(a) As explained above an audit requires the exercise of professional judgement by the auditor. Professional judgement requires a combination of knowledge, experience and the ability to utilise the knowledge and experience effectively. If this judgement is exercised well, the company will receive a service which wins or retains the confidence of the audit committee and management, can be relied upon by investors and other interested parties, is cost effective and is of value to the company's business. Further, given the high level of transparency in the large company audit market and the expertise of the companies (see section 5C below), potential clients will be attracted to a high quality firm. High quality therefore helps win and retain business. In contrast, there can be adverse impact on an audit firm's reputation when an audit is lost because of concerns over quality or when things go wrong.

(b) We compete in the market for recruiting and retaining the best talent. Our closest competitors include other accounting firms and other professional service businesses. If we were unable to recruit and retain talented people we would not be in a position to offer a high quality service to our clients. Graduates and other potential employees are attracted to a business that offers excellent training, a breadth of services, the opportunity to work with leading companies and is recognised as applying the highest professional standards. Quality is therefore important for the sustainability and future growth of our firm.

(c) There is a relationship between the competition to win clients and the competition for talent. We compete in both markets with other audit firms that are highly experienced and are well respected by clients and potential employees. Quality is at the very heart of the competitive process. To recruit and retain the best staff and partners, and to retain and win clients, we are under constant pressure to better the performance of our major competitors. In such

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[62] See Exhibit 17: Transparency Report: Doing the right thing: Delivering quality audits, 30 September 2011, page 8. This has been PwC's strategy and internal message for many years as illustrated by this extract of the Assurance Executive Minutes of September 2008: *"I am concerned that we need to continually reinforce the importance of quality in all that we do in the context of both the current market conditions, as they affect our clients and also the increasing pressure on the Assurance business to grow profitability"* (see Exhibit 18: Assurance Executive Minutes of September 2008).

[63] Exhibit 19: AIU Public Report on the 2010/2011 inspection of PwC, 26 July 2011, page 11.

an environment, a "sufficing" approach – under which we sought to do no more than was necessary to meet regulatory requirements and avoid liability – would not be a viable strategy. Potential and actual audit customers and our staff would soon see the firm's quality as inferior to our major competitors. Given this weakness, clients would defect, talented people would not be attracted to work for us, and those already in the business would leave; this in turn would have a further adverse effect on the quality of our service; and we would then lose more clients and the business would further decline.

(d) Quality is of course important in ensuring that the firm meets the relevant regulatory standards. As explained above, the regulatory requirements do not define some "tick box" audit product in the sense that if the appropriate processes are followed the obligations placed on the auditor are automatically satisfied. While it is necessary to follow the relevant audit procedures and meet the requirements of the regulatory structure, ultimately the test is whether the financial statements give a true and fair view of the company's financial position and results and, as we have shown, this requires the exercise of professional judgement. A culture of high quality in the audit firm, and compliance by the firm with the requirements of ISQC (UK and Ireland), means that there is less likelihood for errors that give rise to regulatory penalties and third party liabilities. This in turn helps ensure that the firm's reputation is maintained.

(e) The consequences of a material misstatement in the financial statements of a large company can be extremely serious for all the stakeholders. For the company concerned, a material misstatement in the audited accounts would be likely to erode confidence in the management of the company and reduce the value of that company's shares. The reputation and competence of the non-executive directors on the audit committee are likely to be severely damaged. The audit firm in question would face the risk of unlimited liability should the audit be shown to have fallen below the required standards (and the reputational consequences of this could be arguably even greater). For the individual auditor, the professional and personal financial consequences of failure to identify such a misstatement would likely be severe. If an audit firm were considered by the market to bear a disproportionate responsibility for audit errors, the consequences for that firm would stretch beyond the individual audits concerned, raising serious reputational issues about that firm and resulting in the loss of business to other audit firms. All audit firms face a constant imperative to eliminate errors and maintain their reputation in the market.

2.35 The importance of ensuring quality audits goes beyond the interest of any one company or audit firm. A high quality audit is a preventative control that enhances quality in financial reporting. The "risk" that the auditor may identify a misstatement acts as an incentive to management to report well in the first place.

2.36 It is of critical importance to the UK economy that the audits of large companies are – and are recognised as being – of a high quality. This is essential to provide reasonable assurance to investors that a company's financial statements as prepared by management can be relied upon. Although (as with any other large and complex business service requiring the exercise of judgement and technical expertise), there will

be occasions when errors occur and where an incorrect audit opinion is issued, this is rare. If such instances were to become anything other than occasional they would start to undermine market confidence in the reliability of published financial statements. Such concerns would have implications for the UK (and the global) economy. Notwithstanding the primary responsibility and legal duty of care to existing shareholders, auditors are aware that their work is available to many other parties, for example the wider capital markets (even though those parties are not in law able to rely on the auditor's opinion). Through their membership of one of the professional bodies, auditors are under the obligation to carry out their work and act generally in the public interest. This acts as a further driver of audit quality.

How quality is assessed

2.37 In order to achieve effective audit outputs it is necessary to have high quality inputs. In this section we consider the inputs that we focus on in order to ensure that our audit service is of sufficiently high quality. We then seek to evaluate how this translates into high quality outputs in section 6 below, in the context of assessing the indicators that competition in the audit market is effective.

The FRC framework

2.38 The Financial Reporting Council (FRC) in its Audit Quality Framework[64] identifies five drivers of audit quality: the culture within an audit firm; the skills and personal qualities of audit partners and staff; the effectiveness of the audit process; the reliability and usefulness of audit reporting; and factors outside the control of auditors but affecting audit quality.

2.39 Taking the first four of the FRC quality criteria (that is, those which are within our control) in turn:

(a) **Culture:** As demonstrated by Ian Powell's and Richard Sexton's statements (paragraph 2.33 above), quality is at the heart of PwC's culture and the message is driven from the top of the organisation and continually and constantly reinforced to all levels of staff and partners. Assurance quality is a key performance indicator (KPI) for PwC and quarterly reports are prepared to record results – with results ultimately affecting individual salary and career progression.

(b) **Skills and personal qualities:** We expend considerable resources in recruiting, training and developing our people and equipping them with professional qualifications to ensure we have the skills necessary to recognise and address the difficult issues of professional judgement that arise in all large company audits. The audit team also use this expertise to provide insight to the company on best practice to address systems and other complex matters and on other aspects, for example industry issues and reporting practices. Personal development training, as well as experience gained on the job, ensures that PwC

[64] See Exhibit 20: Financial Reporting Council *"The Audit Quality Framework"* published February 2008.

auditors develop the "soft" skills that are essential to an effective large company audit service.[65]

(c) **The effectiveness of the audit process:** This is dependent on a number of factors, on which we elaborate in detail in section 3 below:

(i) Necessary geographical coverage: As large companies have grown internationally, so our network has expanded across the world to meet the demands to provide a consistent and trusted audit service across those companies' operations. The preference of large companies to engage a single audit network for their group audit to simplify contracting and reporting, to facilitate consistent quality and to ensure clear accountability, has led to the development of the broad and dense international networks of the largest audit firms over the course of the last two decades.[66] We have invested to ensure that we have a network with geographical coverage to audit the largest global companies.[67] [68]

(ii) Audit methodology and systems: As an example of our efforts in this area, the PwC network of firms has recently invested US$400 million across the globe in a new IT platform to support our audits – the Aura system. This aims to ensure a consistent application of methodology and approach to the audit, including across the different PwC offices that may be involved in carrying out an audit.[69] Costs incurred to implement Aura locally within the UK and other countries are estimated to total the same amount again, and in addition there is significant annual "maintenance" spend.

(iii) Specialist contribution and industry knowledge: To undertake an effective large company audit, a variety of specialists are required to supplement the expertise and knowledge of the audit team itself. These include specialists in IT, controls assurance and accounting standards, as well as tax, treasury, valuation and, from time to time, insolvency experts. For some audits expertise in US accounting and regulatory requirements is needed.[70] It is also useful, and in some cases necessary, for the audit team to have strong industry expertise depending on the company concerned.

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65 See paragraphs 3.15 - 3.19 below for further details on PwC's investment in people.

66 The firm's business plan reiterates the importance of building a consistent understanding of what quality means and how to measure it. (See Exhibit 16: "FY12 and Beyond - Smarter growth".) The firm embraces a 'One Firm' approach to risk and quality (R&Q) by adopting firmwide solutions to improve quality and consistency.

67 See paragraphs 3.28 - 3.34 below for further details on PwC's network.

68 Not only do audit firms supplying audits to large companies need to have a global network but the quality of the service across the network must be, as far as is possible within the constraints of individual territory differences, uniformly high and consistent. This is clearly shown by the feedback PwC receives from its clients. For example see Exhibit 21: [✂]: *"It's important to us to have a really joined up co-ordinated auditor"*; Exhibit 14: [✂]: *"How to provide consistent global approach is always going to be a challenge for PwC or any other professional firm"*; Exhibit 22: [✂]: *"PwC have the best stretch and breadth [of the Big Four]… I think the way the global firm connects is very good now"*; Exhibit 23: [✂]: *"PwC are more joined-up, which is critical for a company like [✂]*; Exhibit 24: [✂]: *"For a global company like [✂] it's very important that we get a consistency of service and approach around the world and I would say that of the Big Four today PwC does that the best"*.

69 See paragraphs 3.35 - 3.41 below for further details on PwC's systems and methodology.

70 See paragraphs 3.20 - 3.27 below for further details.

(d) **Audit reporting:** Audit quality is enhanced by the following means:

(i) Supervision and review: Supervision and review to ensure rigorous internal quality control is undertaken not only to maintain a high standard of quality but also to strive for continuous quality improvement. Our internal review system is comprised of the engagement leader and audit manager supervising the audit, reviewing the outcome of audit procedures performed and evidence obtained, and coaching the team. Key aspects of the audit are also reviewed by a quality review partner, an experienced audit partner who is independent of the core engagement team.

(ii) Monitoring: We seek to ensure that every audit is carried out to the same high standards. The firm seeks constantly to improve policies, procedures and the consistency of the quality of its work. Experienced and independent partners review audits overseen by the PwC network to assess whether PwC's standards have been met, to learn from past experience and constantly to improve the audit service provided to all of our clients. There are financial sanctions for any partner or director with unsatisfactory quality review results.

Other indicators of quality

2.40 There are external measurements of audit quality. We (in common with all other firms that audit companies with listed securities, or other entities in whose financial condition there is considered to be major public interest) are inspected by the AIU, which assesses technical quality by inspecting a number of specific company audits to determine compliance with the relevant regulatory standards. An illustration of the depth and scale of the AIU inspection process is that they have a permanent presence on-site at our main office for the audit of large companies at Embankment Place in London. If, as a result of their inspection, the AIU identifies matters where improvement is required, these will be set out in its report. This is published and made available on the internet (with a more detailed version made available confidentially to the firm). Where concerns arise, the AIU will agree an action plan with the audit firm in order to ensure that their concerns are addressed.[71]

2.41 Audit quality can also be assessed, indirectly, through the review of a company's financial reporting by the Financial Reporting Review Panel (FRRP). The FRRP, which is a body of the FRC, is authorised under the Companies Act 2006 to exercise functions with a view to ensuring that the accounts and financial and other reports – including annual reports and directors' reports – of companies and other entities comply with the law and relevant reporting requirements. A high quality audit should result in compliant financial statements, unless there is a disagreement with management, which, if material, would result in a modified audit opinion. Therefore, if the FRRP issues an adverse finding, citing material issues of non-compliance with relevant reporting requirements in a company's reporting, and the auditor had issued a "clean" (unmodified) audit opinion, this has implications for that company's, and the wider markets', perceptions of audit quality.

[71] Further details of the AIU process are set out in paragraphs 3.45 - 3.50 below.

2.42 Recent AIU and FRRP findings are discussed further in paragraphs 3.45 - 3.54 below. Of course, the AIU and FRRP are focused on technical quality in terms of compliance with regulatory standards. They do not provide an indication of quality in the broader sense, in terms of the company's, or indeed other stakeholders', perception of the service it receives. We must win the confidence of the audit committee, the board and management of our audit clients, and this comes from having high quality people with appropriate back-up and support delivering an excellent service.

F The relationship between the audit firm and the company

2.43 The reference market is for audit services to large listed companies in the UK: professional services provided in the context of business-to-business relationships. Professional services are usually based around relationships; and in the following paragraphs we identify the relevant stakeholders and the nature of the relationship between the audit firm and the stakeholders.

The relevant stakeholders

2.44 There are three stakeholders on the company side with a close interest in the audit:

- the shareholders on whose behalf the audit is conducted;
- the audit committee, a sub-committee of the full board, which ensures that the interests of shareholders are properly protected and has a direct role in the audit engagement and review process; and
- the company management, in particular the finance director, who have day-to-day interaction with the auditor.

2.45 Each of these stakeholders has different interactions with the auditor, has different demands of the auditor, and may have different perspectives on the audit process. This does not mean that there is a misalignment of interests. While the company's management may have a particular interest in, say, improving its internal systems or comparing them with those of other companies, it is also very much in the interest of shareholders that the company's systems operate as efficiently as possible and in accordance with best practice. The modern approach to audit services has developed precisely to address these different needs and ensure that all interests – particularly those of shareholders – are well-protected.

2.46 Interaction with management is necessary across the group being audited and must be responsive to the company's needs at each level. For example, in addition to the company's head office finance functions, there may be interaction with:

(a) the management of subsidiaries within the group where there are material matters to be considered and/or where the company requires a statutory audit;

(b) divisional or regional managements responsible for oversight of a portfolio of businesses in the group; and

(c) internal audit, which has an interest in issues or themes identified by the external auditors.

The relationship with the stakeholders

2.47 As with other professional services, particularly in business-to-business markets, the company is concerned to purchase not just a set of skills (important as those are) but also an effective relationship built around trust and confidence. It is important that the board, audit committee and management respect the professional judgement of the lead audit partner and his or her team, and can build and sustain an effective day-to-day working relationship. The audit committee is particularly focussed on ensuring that the audit has been undertaken to the highest possible quality and that management and internal procedures have been subject to appropriate scrutiny.

2.48 For us the preservation of independence and maintenance of professional scepticism are overriding requirements, and the review and opinion-based nature of the auditor's role is such that it may well involve the auditor challenging the company's management on certain issues and sometimes getting into robust discussions - even on occasion giving the company messages that it would prefer not to receive. Such messages are likely to be better received and respected if they come from a team whose professional judgement and knowledge of the business and sector are trusted and respected by the company's people. In fact, most companies audited by PwC recognise that this is a part of the company/auditor relationship that works well:

(a) [✂]: *"I think [the lead partner] is first class, he adds value and gives his honest independent opinion."*[72]

(b) [✂]: *"The lead partner makes me feel happily uncomfortable."*[73]

(c) [✂]: *"We like to be challenged, we like to respond robustly and have a discussion."*[74]

(d) [✂]: *"My impression is that the audit team is robustly independent."*[75]

2.49 Although these relationships are in part personal, based on the particular attributes of the lead audit partner and other individuals and their interaction with particular individuals at the audited company, it would be wrong simply to characterise them in this way. In our case, the lead partner and other members of the team embody the quality and experience of PwC, are able to utilise our systems and network, and are themselves the product of significant investment in recruitment and training. Their skills and professional judgement are built on experience and the ability to draw on our institutional experience and investment in relationships with other clients, including those of other practice and sector specialisms.

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72 See Exhibit 6: [✂]
73 See Exhibit 25: [✂]
74 See Exhibit 26: [✂]
75 See Exhibit 27: [✂]

2.50 So the term "relationship" in the context of audit and other professional services is a description of an end product resulting from a cycle of investment and improvement, as company feedback shows:

(a) [✂]: *"We all place business with those who we think have the best ideas and are the best people, which comes back to the relationship point".*[76]

(b) [✂]: *"We have a very strong relationship whereby if ever there is an issue, we work together and solve it as soon as possible"*.[77]

(c) [✂]: *"I've dealt with PwC, I've dealt with [✂], I've dealt with [✂], I've dealt with all of them and I would say this relationship and the way it works is about the best I've come across"*.[78]

2.51 Indeed, in audit markets where the lead auditor has to change every five years and where we serve or wish to serve a number of leading companies in all sectors, such investment is critical to ensure that there is a strong cadre of skilled auditors within PwC who can replace each other and maintain relationships with clients over the long term.[79]

2.52 There is significant investment by both ourselves and the company in the relationship. For us, this involves learning about the company's business in the UK and around the world and dedicating a large number of people to the audit in circumstances where there is no guarantee that the relationship will be renewed each year. For the company, this involves building a relationship of openness, trust and confidence and taking the benefit of the advice and support of the audit firm, as well as recognising that a crucial aspect of the auditor role is always to challenge, and at times to be critical.

2.53 Because of this, the relationship is not without tension. For us the preservation of independence and maintenance of professional scepticism are overriding requirements and this sometimes means asking difficult questions and giving the company messages it would prefer not to receive.

G The regulatory landscape

2.54 In the following paragraphs we consider the banking crisis of 2008; describe our views on areas for reform; and explain why we do not support certain regulatory reform proposals.

The banking crisis

2.55 What occurred during the 2008 banking crisis was unprecedented and cannot be allowed to happen again. It gives rise to an obligation on us, and all those involved in

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76 See Exhibit 28: [✂]

77 See Exhibit 29: [✂]

78 See Exhibit 30: [✂]

79 See for example, Exhibit 31: [✂]: *"Team continuity has played an important role in developing an excellent knowledge of the business and [✂] would like this to continue as far as possible"*; Exhibit 32: [✂]: *"I think it's a great team, the skills complement each other, there's a high level of continuity and cumulative knowledge"*; Exhibit 29: [✂]: *"The team continuity provided by PwC has made the audit more a qualitative process"*; and Exhibit 33: [✂]: *"There's depth of quality right across the team."*

managing large companies and monitoring or reporting on company performance, to consider changes that might minimise the risks of such events occurring again. We take that obligation seriously and have engaged with regulators, investors and companies in discussion of reforms and have reviewed our internal processes to consider what changes might better ensure that audit remains relevant and plays its part in a more robust regulatory framework to minimise the risk of a recurrence of the events of 2008. We describe our proposed reform agenda in paragraph 2.59 below.

2.56 Serious as they were, the events of 2008 were exceptional, and care should be taken before seeking to draw any more general lessons from those circumstances. In fact there is no evidence that the audit system failed to fulfil its statutory and regulatory obligations in 2008 (although there is a different debate as to whether the scope of the audit should change). The role of audit in the banking crisis was fully explored by the House of Commons Treasury Select Committee in its inquiries into the collapse of Northern Rock[80] and into the banking crisis[81] respectively, and was also addressed by the House of Lords Economic Affairs Committee in its investigation into the audit market.[82]

2.57 A key issue addressed in each of these inquiries was the basis on which auditors reached unqualified going concern judgements on banks during the financial crisis of 2007-09. These issues were discussed by our Chairman, Ian Powell, in his supplementary evidence to the House of Lords Economic Affairs Committee[83] which included copies of our written evidence to both Treasury Select Committee inquiries referred to above. This illustrates that the purpose of going concern disclosures is to determine the appropriateness of the accounting basis used for items in the accounts and that the auditor's reporting duty is to report only if the audit has identified a material uncertainty that may cast significant doubt on the company's ability to continue as a going concern. A key lesson from the financial crisis was that neither the purpose of these disclosures nor the auditor's reporting duty is well understood and, arguably, that neither meets the common expectations of readers of financial statements.

2.58 This issue has now been considered in the preliminary report by the Sharman Inquiry into going concern and liquidity risks[84], which makes a series of recommendations for changes in disclosure by companies and auditors to improve the existing reporting regime. The inquiry panel seeks in its report to apply the lessons learned from the

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80 See House of Commons Treasury Select Committee report (session 2007-08) "The Run on the Rock" (http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/918/918.pdf).

81 See House of Commons Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, Ninth Report of Session 2008–09, http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf.

82 See House of Lords Economic Affairs Committee 2nd report - *Auditors: Market Concentration and their role,* Volumes I & II (published 30 March 2011), http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf and http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119ii.pdf.

83 See supplementary evidence of Mr Ian Powell to the House of Lords Economic and Monetary Affairs Committee on 4 January 2011, Volume II, page 245 of House of Lords Economic Affairs Committee 2nd report – Auditors: Market Concentration and their role, Volume II (published 30 March 2011), http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119ii.pdf.

84 See Exhibit 34: The Sharman Inquiry preliminary report and recommendations, November 2011. The Sharman inquiry was appointed by the FRC in early 2011 to identify lessons for companies and auditors addressing going concern and liquidity risks and to recommend measures, if any, which are necessary to improve the existing reporting regime and related guidance for companies and auditors in relation to these matters.

exposure of the vulnerabilities of the banks during the crisis more generally to all companies but also considers whether there is a need to develop a special regime for banks.

Priority areas for reform

2.59 It is accepted that the banking crisis undermined public confidence in a number of institutions and services, including the perception of the audit. It is clear that there is a need to consider changes. In this regard we have identified five priority areas for reform and action:

(a) The profession generally has not done a good job in explaining what an audit is and we recognise that it is partly our fault that, outside of the profession and the companies we audit, the role of the audit is not well understood. Over time we would like to see changes to the audit report to make it more comprehensible to those beyond the immediate stakeholders. To this end we have been discussing with some audit committee chairs how far we could make the audit committee's governance report a vehicle for more information. Some audit committee chairs have agreed to try to do this and we understand that five of our FTSE 100 clients did this for the last financial year (2010).

(b) We will continue to strengthen our audit processes to ensure they are as robust as they reasonably can be and we are further developing ideas for increasing our standards of excellence and how such standards are enforced.

(c) Alongside the Department of Business, Innovation and Skills and the FRC, we are considering how the "front half" of the company's Annual Report – the narrative information that goes with the financial statements and is not covered by the audit report – could be improved. At the moment auditors report by exception and we need to find ways of making that feature of reporting more useful.

(d) In the context of calling for changes to the corporate reporting model (of which the audit forms a part), we welcome changes to standards of reporting and auditing that would give clearer and better assured information in the areas that received focus in the financial crisis, for example by providing a greater focus on the uncertainties and judgements that underlie financial statements and the assumptions and sensitivities that underpin going concern assessments. We have made these points in our response to the IAASB on its consultation on Enhancing the Value of Auditor Reporting,[85] to the Effective Company Stewardship paper from the FRC[86] and to the Sharman panel of inquiry on Going Concern[87].

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85 See Exhibit 35: PwC network response to IAASB on its consultation on Enhancing the Value of Auditor Reporting (16 September 2011).

86 See Exhibit 36: PwC UK firm response to FRC on its consultation on Effective Company Stewardship (31 March 2011).

87 See Exhibit 37: PwC UK firm response to recommendations of FRC Sharman Panel of Inquiry on Going Concern (22 December 2011) and Exhibit 38: PwC UK firm evidence to FRC Sharman Panel of Inquiry on Going Concern (24 June 2011).

(e) In the longer term, more fundamental reform to the corporate reporting model is required, including greater governance, fuller remuneration, risk and sustainability information.

2.60 Regulators and policymakers in the UK and around the world have recently examined the role of the audit and of audit firms. As mentioned above, we have presented our reaction to the issues raised by, among others, the Treasury Select Committee,[88] the House of Lords Select Committee on Economic Affairs (2010)[89], and Director General for the Internal Market and Services at the European Commission.[90] We support a number of the changes that have been proposed which we believe may improve overall audit quality and the reliability of financial reporting. These changes are:

(a) the removal of barriers to auditors working across the EU, such as the adoption of a "European Passport" for auditors;

(b) the prohibition of contractual clauses which require the use of a large network audit firm;

(c) the development of plans, at a national level, to ensure continuity of audit service in the event of failure of an audit firm;

(d) changing the rules governing ownership of audit firms and liability reform;

(e) improving two-way communication between prudential regulators and auditors;

(f) augmenting the responsibility of audit committees to act as the main representatives of shareholders by overseeing the appointment of auditors, the execution of the audit and the provision of non-audit services supplied by the auditor;

(g) increased auditor assurance on certain financial information relevant to the market place;

(h) the consistent use across Europe of ISAs to enhance consistency and confidence in the quality of audits; and

(i) ways in which audit reporting might be made more relevant to evolving market needs. These are the subject of separate consultations of the IAASB and the PCAOB.

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88 See House of Commons Treasury Committee: Banking Crisis, Volume II pages 311-315 (http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144ii.pdf).

89 See Volume II of House of Lords Economic Affairs Committee 2nd report – Auditors: Market Concentration and their role (published 30 March 2011), http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119ii.pdf.

90 See Exhibit 39: PwC response to Green Paper on Audit Policy to Michael Barnier on 8 December 2010.

2.61 There are other regulatory proposals that we do not support because we believe that they will undermine audit quality, negatively impact the competitive process with no compensatory public interest gain, and be unduly costly. These include:[91]

(a) mandatory rotation of audit firms – which has been shown to diminish audit quality and increase costs while not encouraging a wider range of firms to secure audit appointments (because rotation does not provide smaller firms with the necessary attributes);

(b) restrictions on the tenure of audit firms, or greater restrictions on the services those firms can provide to audit clients – which would increase costs for businesses and restrict the ability of companies to determine the most suitable service provider for either audit or non-audit services, and which are likely to reduce audit quality and, coupled with mandatory rotation, could decrease rather than increase the number of firms able to carry out audit of FTSE 350 companies;

(c) audit-only firms – which would decrease the quality of audits by limiting the experience available to individuals at audit firms, restrict the ability of businesses to select the most efficient and effective service provider and increase costs by requiring the buying in of specialist skills; and

(d) joint audit (now proposed on a voluntary basis) – which has been tried and abandoned in some countries because it adds to cost and reduces clarity of accountability and hence threatens quality.

2.62 It is noteworthy that UK companies are already free to exercise their choice of audit firm using principles and approaches that would effectively implement a number of the regulatory proposals described in the preceding paragraph. However, they choose not to do so. For a regulator to conclude that intervention is required, the regulator would effectively be saying it needs to intervene to require companies to take actions they are currently choosing not to take. Given that the companies in the reference market are the largest and most sophisticated in the UK, to reach such a conclusion would require strong and consistent evidence that there were clear and understandable reasons why such buyers should allow such a position to persist when, as customers, they would likely be the parties disadvantaged. As noted above, there are clear reasons why the regulatory proposals would have adverse effects on the price and quality of the audit services received by companies, which explains why companies voluntarily choose not to procure audit services that such regulators proposals would seek to enforce.

H The four pillars and the supporting evidence

2.63 Having explained these important background aspects, in the next four sections of the submission we explain the evidence that supports our understanding of how the market operates - based on our own market experience and, as importantly, the views and behaviour of our clients - that:

[91] There are other proposals for change that have been suggested from time-to-time which we shall address during the course of this inquiry.

(a) large companies require their audit firms to have specific skills and attributes necessary for the delivery of a quality and efficient audit to large and complex companies (see section 3 below);

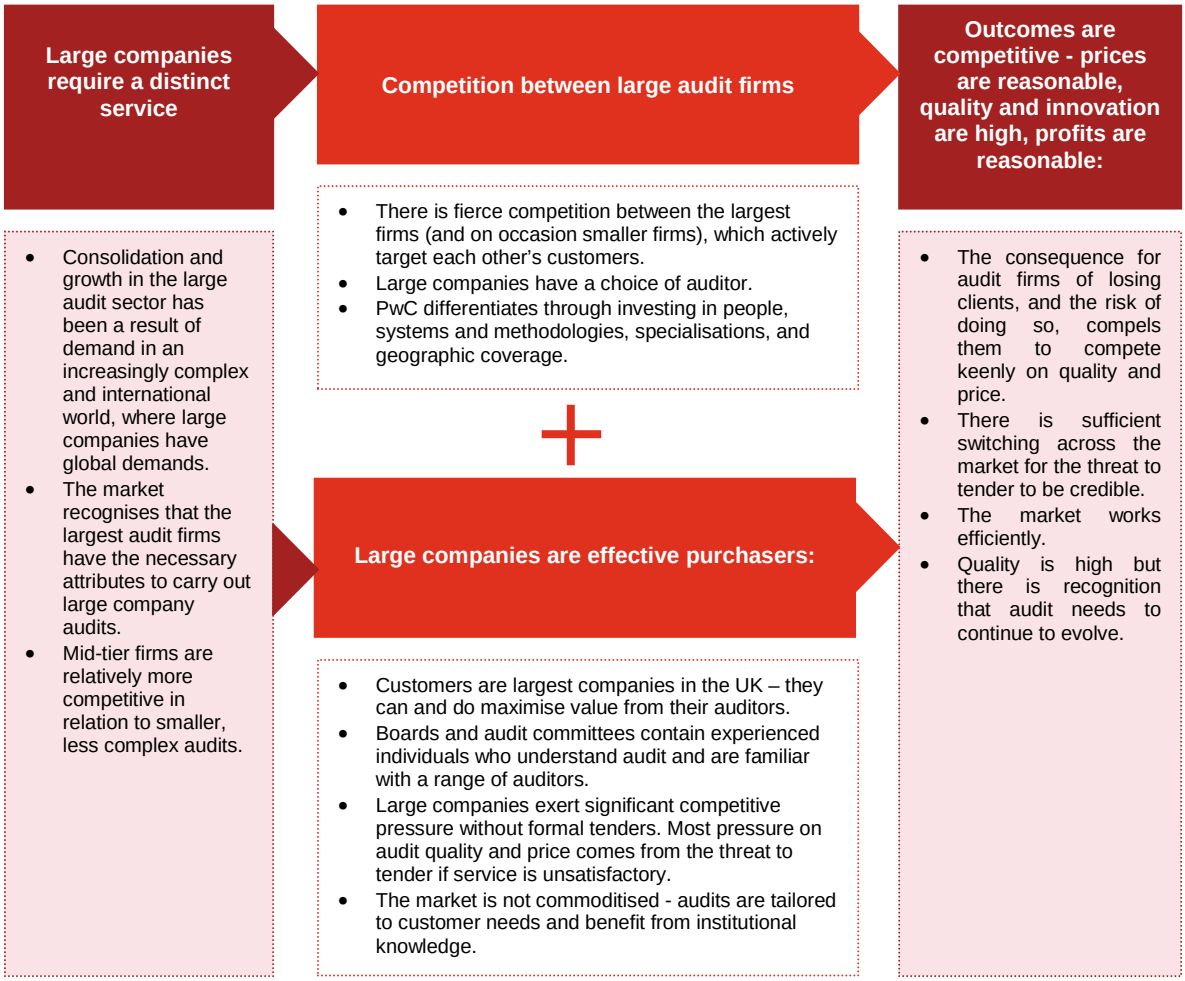
(b) there is vibrant competition between audit firms with the necessary skills and attributes (see section 4 below);

(c) large companies are effective purchasers of audit services, well able to judge and demand quality and value in the audit services they receive (see section 5 below);

and this means that

(d) prices for large company audits are reasonable, profits are not excessive and there is high quality and innovation (see section 6 below).

Figure 1: "The four pillars"



The relevant evidence

2.64 Much of the relevant evidence to support each of these four pillars is drawn from our internal processes of monitoring and gathering feedback from companies on the performance of our audit teams, inside and outside formal tender processes. When this evidence is properly considered, the basic supposition of paragraph 10 of the Issues Statement – that the features described in paragraph 9 suggest an absence of "rivalry" – falls away, and with it the basis on which the various theories of harm are founded.

2.65 We consider it important to provide ample evidence in this submission to demonstrate the characteristics of how the market operates, which is key to understanding the extent of competitive pressures under which we operate. Inevitably much of the evidence relates to our own experience in the market although we have drawn on wider market data where this is available.

2.66 We recognise that, in addition to the evidence held by us (and the other audit firms), the perspective and behaviour of the large companies that require and receive audit services are important to the CC's analysis and we welcome the fact that the CC will approach large companies directly for this information.

2.67 We set out below a summary of the main categories of evidence that we will refer to throughout this document. This evidence has not been collected in preparation for this, or for any other competition or regulatory investigation. Rather, it consists of material and data collected as part of our usual business activities to help us understand the views of audit customers and prospective customers to ensure that we continue to offer the highest quality services, satisfy requirements of clients and compete effectively. Clearly, we would not need to expend time and effort in compiling this information if we faced only "limited rivalry". These sources of information include:

(a) **Client Perspective Reports (CPRs)**, which are detailed reports of how clients regard our service, compiled following interviews with audit committee members and management carried out by an internal support team (which is entirely independent of the audit delivery team). These are to help us understand what we do well, what we could do better and how we compare with our rivals.

(b) **Independent Senior Partner Reviews (ISPRs)**, which are typically less detailed and more informal reports than CPRs, but which share the same objective. They are interviews with audit committee members and senior management of our existing clients, conducted by a senior PwC partner independent of the audit team.

(c) **Client Satisfaction Surveys (CSSs)**, which are assignment level surveys of company management who interact with the audit team. The survey involves clients ranking what they view as important about our performance on a scale of one to ten against various criteria.

(d) **Post Decision Reviews (PDRs)**, which are reports prepared by the internal proposal support team following interviews with management at companies for whose audits we have tendered. This is to understand why we won or lost the

tender, what we did well and how we might improve, and how we compare with our rivals.

(e) An **Audit Relationship Risk Diagnostic (ARRD)**, which is a tool we have developed to allow us to identify those audit clients that are "at risk" of being lost based on a range of different metrics. This tool analyses the data on "risk of loss" characteristics provided by the partners responsible for large company audits and rates the risk for each company against the various criteria.

2.68 We also refer to **requests for proposals (RFPs)** from companies and **tender proposals (Proposals)** that we have submitted to attempt to retain or win an audit of a large company. RFPs give evidence of a company's particular requirements, demonstrating the bespoke and complex nature of large company audits. Proposals show how we have sought to demonstrate that we have the attributes and ability to audit a particular company in competition with rival suppliers.

2.69 This material, from our current, former and prospective clients, illustrates where we have succeeded in meeting the demands and expectations placed upon us, but also where we have failed (for example, in unsuccessful tenders). The reasons for both the successes and the failures are of course important. They illustrate vividly the competitive pressures that we face on a daily basis. The evidence shows what we need to continue doing, but also what we must improve upon to succeed in the future. It also illustrates clearly how we compete with, and compare with, our rivals.

2.70 A list of our 108 current audit clients as of the end of Q3 2011 that are within the FTSE 350 is set out in Annex 3 to this submission. This table shows the company's current FTSE ranking and sector, together with an indication of whether we hold a CPR, ISPR, Proposal or PDR for that company (with a reference where relevant).[92]

[92] Certain of these tools apply to all FTSE 350 clients, for example the CSS and ARRD.

3 The first pillar: Large company audits require specific skills and attributes

In this section, we address the first of the four pillars – that large company audits require particular skills and attributes which the largest audit networks are able to provide consistently and on a global basis. In particular we address:

A How the growth and complexity of large companies led to the evolution of PwC and other large audit firms to meet the demand for complex and global audit services

B The attributes that PwC has developed to meet the demands of large companies, in terms of people and performance, specialist and industry expertise, international coverage, audit methodology and compliance systems

C That these attributes are required by companies throughout the FTSE 350 and not only by the very largest companies

D The gap between the mid-tier firms and the largest audit networks and why large companies typically appoint the largest audit firms

A How the growth and complexity of large companies led to the evolution of PwC and other large audit firms

3.1 In the following paragraphs we explain how the pace of globalisation over the past 25 years (which has accelerated as national economies have become more interconnected) has led to nearly all large companies that are listed on the FTSE 350 having relatively complex corporate structures and sophisticated operating systems, many with substantial global operations. This growth and complexity has required audit firms who wish to serve this market segment to develop their expertise and international networks in response. It has also led to more demanding and international regulatory standards, which in turn has reinforced the importance of audit firms having a coordinated and consistent standard of service across the network.

The growth and complexity of large companies

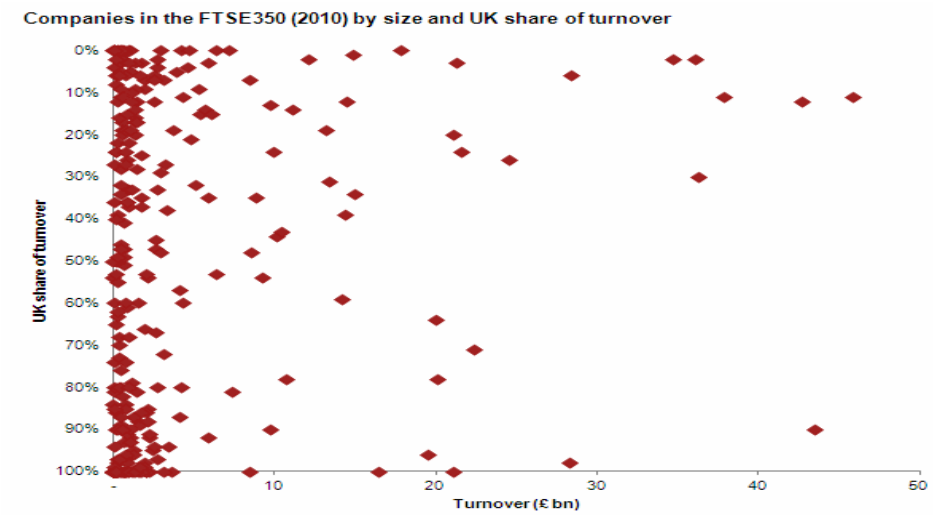
3.2 The correlation between the increased complexity of the structure of large companies, the increased complexity and sophistication of corporate reporting and the evolution of audit firms was recognised by Roger Marshall of the Accounting Standards Board, who stated on 18 January 2011 to the House of Lords Select Committee on Economic Affairs: *"I think that standards have become more complex as businesses have become more complex ... those more complex standards … require more skills from*

auditors. That probably tends to push up the optimum size of audit firms, because they do need these specialists."[93]

3.3 Large companies have always carried out a substantial amount of international business. As David Hobbs, director of FTSE International, noted on 4 May 2008: *"I don't think the FTSE has ever really been a proxy for the UK economy. Even as far back as 30 years ago, more than half of UK profits came from overseas, although then it was more export-led because of overseas production, but if you look at the largest companies, they have always been multinational."*[94]

3.4 The chart below shows the revenue of current FTSE 350 companies and the percentage of their turnover which was generated outside the UK in 2010. It shows that there is no clear correlation between the proportion of revenue generated overseas and the size (measured by total turnover) of companies within the FTSE 350. In around half of cases within the FTSE 350, the majority of turnover is non-UK,[95] and in many cases almost all turnover is generated outside the UK. As this chart shows, it is not only for largest companies in the FTSE 100, but throughout the FTSE 350 that these companies are truly global in their operations, and therefore the importance of an auditor having an established and reliable global network is paramount.

Figure 2: International business in all parts of the FTSE 350[96]



Note: This table excludes companies with a turnover greater than £50bn to avoid distorting the scale of the graph - those companies being BP, Shell, HSBC and Tesco. Source: PwC analysis of sample of 330 companies from FTSE 350 where data available.

93 See page 343 of House of Lords Economic Affairs Committee 2nd report – Auditors: Market Concentration and their role, Volume II (published 30 March 2011) (http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119ii.pdf).

94 See Exhibit 40: http://www.telegraph.co.uk/finance/economics/2789384/The-Telegraph-20-Index-FTSE100-no-longer-a-true-picture-of-UK-plc.html.

95 PwC has data relating to 330 of the current FTSE 350. Of these, 154 achieve more than half of turnover outside the UK.

96 Turnover data is obtained from Datastream. The disclosure of the geographic split of revenues for FTSE 350 companies is of variable quality. For this reason we have used a range of sources to generate Figure 2 above. This includes the FAME database of company accounts and direct inspection of the notes in company annual reports. In some cases we have needed to exercise judgment as to the amount of UK turnover. For 20 companies we were unable to identify any disclosure of the international source of company revenues.

What is involved in auditing a large company

3.5 An illustration of the complexity and scale of carrying out an audit for one of the UK's largest companies is that of [✂], which had annual turnover in 2010 of [✂] billion. [✂] products are sold in over [✂] countries worldwide, and [✂] employs over [✂] people. It is listed in the [✂], and it has listed subsidiaries in [✂]. Auditing the [✂] group involves a team of over 750 audit staff, including over [✂] audit partners, drawn from across the PwC network of firms, working across 95 different worldwide locations. In total, the annual work effort necessary to deliver an audit on this scale amounts to approximately 200,000 audit hours. The team includes specialists in corporate reporting, tax, valuations, sustainability, forensics and treasury amongst others. The UK audit team is required to travel extensively throughout the year to the various [✂] businesses around the world to ensure that the global audit approach is consistent, to address particular issues, and to ensure that the company receives the service it requires.[97]

3.6 While the size and complexity of the [✂] audit makes it one of the more demanding that we carry out, it is nevertheless representative of the challenges and logistical demands placed on us across our large audit company portfolio. An example of a smaller company audit is [✂], a FTSE 250 company with an annual turnover of [✂] million in 2010 and operations in 15 countries, predominantly in Europe. [✂] employs over [✂] employees in over [✂] service centres in operations ranging from [✂], to providing a range of products for [✂]. The PwC network has audit teams servicing this company in each of these 15 countries. In addition to running the consolidation and head office audits and working with management on all aspects of external financial reporting, senior members of the UK group audit team regularly travel to conduct site visits and attend clearance meetings with country management and local audit teams from PwC network firms. We also need to involve non-audit specialists, such as from tax or actuarial, from across our firm (and other PwC network firms) in order to provide the expertise required for a quality audit service.

The evolution of PwC and the other large audit firms

3.7 As large companies have expanded across the world, they have expected and required their professional advisers to be able to provide a consistent, connected and global service that mirrors their own organisations. The consolidation that this has given rise to was a natural consequence of changes in the customer markets brought about by such globalisation. Economies of scale and scope are a natural feature of audit markets, the importance of which has been enhanced by changes in the world economy over the last 25 years.

3.8 This was a trend that was apparent by the mid-1990s. As noted in *The Economist* in March 1997: "*To attract multinational clients, [professional services organizations] now need offices in the world's most important markets and expertise in a wide range of disciplines. To attract the right kinds of recruits, they must be able to offer them a*

[97] In addition to having three teams responsible for regional coordination of the local audits and group reporting (which mirrors the client's management structure) the group audit team consider that they spend approximately 750 to 1,000 hours per year in overseas locations discussing audit quality and service delivery with local engagement teams.

global career... but above all, it is the need for speed and knowledge that has decisively shifted the balance in favour of size."[98]

3.9 The growth and development of PwC and the other large audit firms is described in more detail in Annex 4. In summary, for PwC, the consolidation in the audit market culminated in the merger of Price Waterhouse and Coopers & Lybrand which was cleared by the European Commission on 20 May 1998. As the merger proposal makes clear, the main driving force behind the merger was the need to adapt to changing demands from clients in an increasingly globalised world:

"As a result of these business trends, our clients' service requirements are changing. Clients are looking for new innovative solutions and are demanding more from their professional service providers. They are demanding and receiving focused, high-value solutions with an emphasis on:

i. Seamless global service

ii. Quick, responsive service

iii. World-class capabilities

iv. Local presence

v. Strong implementation capability."[99]

3.10 A desire on the part of clients for broader geographic coverage is highlighted as one of the key reasons for the merger:

> *"Our clients continue to expand on an international basis – some globally, some regionally. We believe a strong position in all priority geographic markets and the ability to deliver global seamless service are important success factors."*[100]

3.11 That large, multinational companies demand an audit firm with a broad international network was confirmed by the European Commission in clearing the merger:

> *"The parties contended that large multinational companies who need access to the international capital markets purchase audit services only from audit firms with both an international network and a recognised international reputation. This contention was corroborated by the different operators in the market during the course of the Commission's market investigation."*[101]

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98 See *"A survey of management consultancy - The quest for size: Either be huge, or be specialised; nothing else will do"*, March 20 1997, http://www.economist.com/node/145631.

99 See Exhibit 41: [≫]

100 Ibid, [≫]

101 European Commission Decision in Case No IV/M.1016 - *Price Waterhouse / Coopers & Lybrand*, paragraph 28.

B The attributes developed by PwC to meet the demands of auditing large companies

3.12 The audit requirements of the largest companies necessitate significant investments on the part of the audit firms in securing the talent and experience to understand the complexities of the world's leading companies, and the systems and network to undertake and manage global audits effectively. We have over time made significant and sustained investments in our UK operations, while also being a key firm in the development of the PwC global network of firms in order to provide a network service that can meet the global needs of large companies headquartered in the UK and elsewhere.

3.13 This investment has been, and continues to be, in response first and foremost to the demands placed on us by large companies, recognising and responding to the fact that our principal rivals – being Deloitte, Ernst & Young and KPMG – are required to respond to the same challenges. It is also necessary to comply with ever-increasing regulatory requirements, which prescribe and enforce the regulations required to assure the wider capital markets that the audits of the UK's largest companies have been carried out to the requisite standard (regulators in other countries have similar objectives).

3.14 In this section we describe six attributes that PwC has developed and which are necessary to audit large companies, which are as follows:

(a) appropriately skilled people, in terms of intellect, technical skills, experience, and number;

(b) specialist expertise;

(c) industry knowledge;

(d) appropriate geographical coverage;

(e) a consistent audit methodology, and systems to ensure the consistent application of the methodology across the network; and

(f) the required compliance systems covering quality standards, auditor independence, money laundering, client acceptance, ethical standards for professional accountants and other aspects of business ethics.

The first attribute: Appropriately skilled people

3.15 Our ability to attract, develop and retain the brightest and best people is critical to our ability as a firm to deliver the highest quality work to the most demanding and sophisticated companies in the world, thereby ensuring that we can compete effectively with the other large audit firms. As explained in section 2.22 above, the exercise of professional judgement is an important aspect of conducting an audit, and this can only be developed through knowledge and experience. We outline below our efforts and the costs involved in developing our people, first describing the importance of the lead

audit partner and then outlining the resources we devote to recruiting and developing our talent.

The lead audit partner

3.16 The audit is led by an individual partner, who is required to put his or her name to the audit opinion. While always supported by a team, it is the individual partner who is critical to the effective delivery of an audit. The lead partner personifies the time, effort and investment made by the firm in all of our people, since it is the graduate recruit of today who is the potential lead audit partner in typically 20 years' time (or even longer for the very largest, complex companies).

3.17 The lead partner is critical in helping us to differentiate our offering from that of our competitors:

(a) [✂]: *"He is respected because he has got the experience that he brings from other clients";*[102] "*[The partner] is 'top notch', the best I've ever seen"*; *"…always looking to challenge and at the same time pass his own views."*[103]

(b) [✂]: *"The meeting with [the partner] was leagues ahead of the other firms as [the partner] was able to give insight which the others were not able to do and were described as being very generic."*[104]

(c) [✂]: *"[The partner] is very constructive and part of a team whilst still "nicely independent"…* "*impressed with how he has 'clearly' made his own mind up on a significant number of key issues after taking over…" "….he described [the partner] as every bit of what I would expect in a world class lead partner."*[105]

Recruiting, developing and retaining talent

3.18 The lead partner personifies our audit offering to the companies we audit, but his or her success is dependent on supporting resources, of which the quality and training of our personnel is of paramount importance.[106] We therefore devote significant resources to recruiting, developing and seeking to retain talented people:

(a) **Attracting the best people:** In seeking to attract the best people we are actively engaged in the "war for talent" with not only the other audit firms, but a wider range of professional services firms, companies and other employers that the brightest people might be attracted to join:

(i) Across the firm in 2011, we employed over 3,400 new people of whom over 1,700 people joined the Assurance LoS. The Assurance LoS

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102 See Exhibit 9: [✂]

103 See Exhibit 42: [✂]

104 See Exhibit 43: [✂]

105 See Exhibit 44: [✂]

106 Many of the skills and personal qualities of our audit people are relevant to all our LoS as a professional services firm. As a consequence, our high-level strategy for recruitment, engagement, development, diversity and remuneration is consistent across the firm. The range of issues addressed as part of PwC's "People" focus (e.g. recruitment, resourcing and leaver rates, current secondment flow, director mobility, talent and reward, employee engagement and communication) is illustrated by our regular briefings on People issues. See [✂].

recruited over 800 graduates in the year ended 30 June 2011 who will work towards achieving qualification and membership of professional bodies such as the Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants of Scotland, or Association of Chartered Certified Accountants.

(ii) The total recruitment costs associated with our graduate intake amounted to approximately [✂] in FY11 (excluding LoS time and salary costs for intern programmes). In addition to recruiting graduates, we invested heavily in a new intern programme with 180 interns gaining experience in Assurance.

(iii) Our success in the graduate recruitment arena has been recognised in the market with PwC voted the country's leading graduate employer in 2011, according to *The Times* Top 100 Graduate Employers survey, for the eighth successive year.

(iv) Our University Partner Programme with Newcastle University ("Flying Start") provides some 50 undergraduates each year with the opportunity to study for a degree, to qualify towards their ICAEW and to have business placements with us. A similar programme is being developed with Reading University.

(b) **Development:** This happens throughout an individual's career through a combination of experiences, relationships and education. This is referred to as the "70:20:10 principle". This principle is based on research which suggests that 70% of learning is achieved through on-the-job tasks, experiences and problem-solving, 20% through learning from others through coaching and mentoring and the development of relationships, and 10% from formal training:

(i) The total direct cost of staff development for FY11 was [✂] (including around [✂] relating to the Assurance LoS).[107] In addition, there are time costs associated with Assurance staff undertaking the training; for example, about [✂] days were spent on Assurance technical training and professional qualifications at a cost of approximately [✂]. Assurance LoS staff also attend business knowledge and skills based training with staff from other LoS.

(ii) Capabilities and technical competence are developed through work experience, coaching and training[108], and are regularly reviewed. As part of our appraisal process, partners and staff assess their ongoing personal development needs and identify any necessary development activities, including in relation to quality. Unsatisfactory work results in reduced performance-related remuneration.

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107 This includes direct costs of training but excludes L&D staff & staff related costs, internal tutor costs, or staff attendance (time or travel) costs.

108 The training and development programmes cover technical auditing and accounting training, regulatory training (independence, money laundering, fit for purpose etc), sector specific training and also "softer" skills training (leadership programmes, presentation skills etc).

(iii) To ensure development is consistent across the network, we bring emerging leaders from South America, Africa, Asia and Europe together to work with our Assurance teams in the UK for two years as part of PwC's World Experience Programme. During FY11 some 203 inbound secondees from other network territories were working with our UK Assurance teams, including those on the World Experience Programme.

(iv) Many of our people spend time on overseas secondments to other PwC network firms in order to provide UK experienced professionals to service our clients and also to develop the skills and experience of our people. For example, PwC in London was able to offer to transfer people with the required expertise to Zurich for [✂]; to Singapore for [✂]; to Philadelphia for [✂] and to Kazakhstan for [✂]. At any point in time about [✂] of our UK Assurance staff are seconded to other parts of the network to support the delivery of UK audits.

(c) **Retention:** We seek to retain those individuals who we recognise have the ability and personal qualities necessary to become partners, as well as our existing high-performing partners. This is achieved through a range of measures, designed to ensure that our people feel that they are valued and that their career is progressing constructively including remunerating individuals in line with market expectations. Our people voted for PwC to be recognised as one of the top big companies to work for in *The Sunday Times* annual survey for 2011, and PwC was listed as the leading employer of women in *The Times* Top 50 Employers for Women 2011. Such recognition helps our drive to attract and retain the best people.

3.19 Finally in respect of our approach to people, it is important to refer to what we call "The PwC Experience", which is a comprehensive global framework that defines how working with PwC as a client, or for PwC as a member of staff, should feel. We track and manage our performance in a number of categories, including levels of engagement, the way we treat our people and clients, the strength of our brand and inter-office mobility. The PwC Experience complements the more formal people strategy that is described above.[109]

The second attribute: Specialist expertise

3.20 The second attribute required to carry out a high quality audit of a large company is to have the requisite specialists on-hand across the network. Whilst the planning, management and process skills and expertise to carry out a large company audit may be transferable from one company to another, the specialist input that might be required varies considerably depending on the nature of the industry sector (for example, particular expertise is needed in the banking, insurance, oil and gas and retail sectors) and also the specific skills needed to support the core engagement team of the company.

[109] The firm's business plan, FY12 and Beyond - Smarter growth (see Exhibit 16) describes the PwC Experience and how it is brought to life. This is done by: investing in relationships; sharing and collaborating; putting ourselves in others' shoes and enhancing value. By implementing these behaviours, clients experience a distinctive and valuable service.

3.21 There are many types of specialists that are required to provide a high quality audit to large companies and it is only PwC and, to different degrees, the other three largest audit firms that have invested to develop these specialist teams to audit all large companies. These include the following, which are described in more detail in Annex 5:

(a) **Controls assurance / IT specialists:** We have around 400 Controls Assurance specialists in the UK. Large companies increasingly rely on IT systems with automated procedures to process a high volume of common transaction types. Ensuring that these systems have been properly evaluated to determine their robustness and sophistication is necessary before the audit team can reach an informed judgement on the reliability of system generated information and therefore the nature of evidence gathering procedures that is appropriate. With this understanding, an efficient audit plan can be deployed that avoids the need for ongoing validation of the many automated functions and reports.

(b) **Accounting technical specialists**: The growth of accounting standards in the UK and, more recently, globally with the development of International Financial Reporting Standards (IFRS), has required a greater awareness of these developments both by companies and by PwC. We have had an established Accounting Consulting Services (accounting technical) team for many years. The demands on the team, and its size, have increased considerably since the introduction of IFRS for UK listed companies. The team in the UK is now 42 highly experienced partners and senior staff; the senior accounting technical partner is supported by five partners, six directors and 30 senior managers and managers.

(c) **Other practice area specialists**: Supplying effective audit services to large companies requires us to draw on the expertise of a wide range of specialists from across the firm, including tax, treasury, valuations, actuarial, insolvency and economists. These teams provide non-audit services directly to non-audit clients, but importantly assist the audit team in providing high quality audits where technical and complex issues affecting the financial statements arise. The specialists' advice can be at either at a relatively high level to offer a view as to the significance or otherwise of an issue, or in a considerable level of detail as required.

3.22 Different companies will of course have differing requirements for this type of specialist advice. For example, when auditing an insurance company, one of the key costs for the company is its payouts to holders of its insurance policies. Insurance companies typically use complex models to assess the amount of claims. Actuaries are needed for effective review of such models. Without the ability to call upon such actuarial specialists, no auditor could give any assurance on one of the fundamental line items of the balance sheet of an insurance company. Other illustrative examples of how this specialist expertise is required by large companies and how they have been relied on by us to demonstrate to companies that we have the capability to carry out the audit, include the following:

(a) [✂]: "*A respected actuarial team is a key ingredient to the expertise of the audit firm. … The use of IT experts within the audit team* is *increasingly important as technology advances improve our control environment.*"[110]

(b) [✂]: "*[PwC team] have shown to be pragmatic and have dealt with accounting technical matters in a manner that [✂], the previous incumbents, may have struggled with".*[111]

(c) [✂]: *"Availability of experts for specialist areas of the audit."*[112]

3.23 All FTSE 350 audit appointments require an element of "specialist" (i.e. non-Assurance) input. Around 85% of audit appointments require input from the Advisory LoS, and approximately 96% require input from the Tax LoS. Although the hours recorded by these specialists may be relatively low as a proportion of the hours recorded overall on the audit, in our experience these are typically high-value inputs which are essential to the audit.

3.24 These specialists are not employed full-time on audit work. The vast majority of the time spent by such specialists is devoted to providing other services in their respective businesses. If these specialists were restricted to providing audit service only (for example if there were a regulatory requirement that auditors should not supply any non-audit services), this would have a serious detrimental effect on our ability to provide the quality of service we are currently able to offer large companies:

(a) The number of specialists required solely to support the audit service would inevitably mean that we would not have the same strength in depth and range of expertise that we are currently able to call upon.

(b) Those specialists that currently spend the majority of their time providing complex non-audit services would be unlikely to be attracted to a role of purely audit-support work and this would make it unlikely that we would be able to recruit and retain such specialists to work on our audits; even if we could, their quality and experience would be reduced by the inability to take on non-audit work.

(c) The absence of the required specialist resources from the audit firm might mean that it would be necessary to call upon external advisers, which might make the audit significantly more expensive and would certainly run risks inherent in engaging third party contractors (such as liability risks, failure to apply common methodology, specification misunderstandings, etc). In some cases the need to involve external specialist advisers might be complicated because of independence issues. If this led to the audit firm trying to undertake the audit without involving specialists, this would reduce the standard of the audit, and thus the overall audit quality.

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110 See Exhibit 45: [✂]
111 See Exhibit 46: [✂]
112 See Exhibit 47: [✂]

The third attribute: Industry knowledge

3.25 The third attribute is that large companies typically require their audit firm (including throughout the global network) to have knowledge of their industry sector, particularly if the sector is itself highly complex, specialised or regulated, such as financial services. This industry expertise is important for the audit team to understand and evaluate the business and identify and respond to the key areas of audit risk.

3.26 To meet this need, we participate in a global industry programme to ensure, amongst other things, that we share the latest industry developments.[113] This understanding helps our audit teams to identify and resolve issues at an earlier stage, and also brings insight to management. The following comments, which are taken solely from the insurance sector by way of an example, show how clearly companies value this expertise:

(a) [✂]: *"Crucial for the auditor to have a wealth of insurance specific knowledge and are able to talk comfortably with the company about industry best practice and solutions available to related accounting issues."*[114]

(b) [✂]: *"demonstrable speciality insurance/reinsurance expertise. The ability to provide comment against a backdrop of experience should promote audit efficiency and will provide the company with value added relative commentary on its control environment and judgemental issues."*[115]

(c) [✂]: "*first criteria for him was insurance industry expertise and according to that he would rate PwC, [✂], [✂] in that order.*"[116]

3.27 The following comments from Proposals and PDRs illustrate how we apply our industry knowledge in addressing our clients' needs:[117]

(a) [✂]:[118] We explained the extent and importance of our expertise in, and know-how of, the insurance industry. We consider ourselves the leading audit firm for insurance and asset management companies with financial services resources in excess of 34,000 professionals globally. As a result, we are able to offer insurance thought-leadership on issues of strategic importance and could assist companies on how best to address new regulatory requirements such as Solvency II. Thus, as was later recorded "*There was discussion about the*

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113 We also transfer industry knowledge around the world through technology, participation in training courses, publications and cross-border secondment or full-time transfers of people.

114 See Exhibit 48: [✂]

115 See Exhibit 45: [✂]

116 See Exhibit 49: [✂]

117 See also Exhibit 50: [✂]: The audit committee chairman is of an opinion that *"the role that PwC plays in the [✂] industry is exceptional. He believes our publications on the sector are of the highest class, as indeed are the publications and other support we give on the role of Directors, Audit Committees etc. He believes that compared with his auditors at [✂] he believes we are significantly better in terms of the quality of our output"*. Exhibit 51: [✂]: The client is of an opinion that PwC *"have great depth and breadth of expertise in the sector"*, *"understands the ebbs and flows of the business"*, *"adds value"*, are *"very responsive"* and have *"great sector knowledge"*. Exhibit 52: [✂]: *"They recognised our knowledge of [✂] in particular and of the industry generally and believed that was an important part of what we could bring to them"*.

118 See Exhibit 53: [✂]

hassle of change but there was also a 'genuine desire to work with the best team we could find'"[119] which resulted in PwC being appointed.

(b) [✂]:[120] We emphasised our industry expertise in the energy sector. We have a global energy industry group that meets regularly to discuss trends, future issues and best practice. The group focuses on sharing the latest research and points of view on emerging industry trends; locating individual experts on each issue, wherever they are based; developing industry-specific performance benchmarks, based on global best practices; sharing methodologies and approaches in complex areas such as financial instruments and tax provisioning; and collaborating on accounting or technical issues unique to the energy industry, especially when interpretive guidance is needed. Thus, when asked whether our lead in the oil and gas sector was considered a positive, the company responded "*both from the knowledge of [our] staff and [our] ability to invest in [them], [they] believed it was a positive*."[121]

(c) [✂]: We explained that we had a pan-European Real Estate network and recently deepened our Real Estate expertise with the hiring of further specialists.[122] However, we lost this audit to Deloitte who put forward a property specialist as the lead audit partner whereas it was perceived that the proposed PwC audit partner "*didn't bring the property industry expertise - he wasn't in the [British Property Federation] - no doubt he was in whatever the retail equivalent of that was [but the] key question was 'how does this stack up with your other clients?'"*[123]

(d) [✂]: "*All of the Big 4 could do the audit but given the company's intention to expand its gaming business, particularly in Europe, and so they saw some auxiliary value in having the audit team that was very familiar with the gaming industry and one who they had worked with previously in relation to gaming matters."*[124] However, we failed to win the audit: *"The difference between EY and PwC was wafer thin. What had swung it EY's way was their greater focus on gaming within the audit team.*"[125]

(e) [✂]: "*They wanted a firm with strength and depth across the whole business. For [✂] this included three important attributes – [✂] and Plc issues. The Plc corporate things were important as [✂] had had to deal with a number of such issues in recent years, including a reconstruction and a share scheme. They had generally been very pleased with the service that they had received from PwC in the Plc area, "always one or two caveats". In respect of strength in depth, PwC was best positioned. Other firms had strengths in particular areas and indeed, in parts, were very impressive, but were not able to match across the piece*."[126]

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119 See Exhibit 54: [✂]
120 See Exhibit 55: [✂]
121 See Exhibit 56: [✂]
122 See Exhibit 57: [✂]
123 See Exhibit 58: [✂]
124 See Exhibit 59: [✂]
125 See Exhibit 60: [✂]
126 See Exhibit 61: [✂]

The fourth attribute: International coverage

3.28 The fourth attribute is consistent international coverage, which, as described above, is required to match the geographic expansion of large companies and has led to the evolution of the PwC network and the other competing large audit firm networks. Large companies have chosen to use a single network with common standards, methodologies and systems for their group audit rather than rely on local audit firms in different countries. Using a single coherent network reduces the risks of an inappropriate audit strategy being adopted which may fail to detect misstatements (the adverse effect of which can be very substantial), ensures that a more consistent methodology is applied throughout the corporate group, and should also result in a more efficient and therefore cost effective service.

3.29 As "The Hundred Group" of Finance Directors stated in their letter of 27 September 2011 to the House of Lords:

> *"For our members, however, the importance of 'global reach' in an audit firm is imperative. The majority of our member organisations are global in reach and, with trade barriers opening up and market growth projections persistently dominated by developing markets we see huge growth possibilities outside the European Union.*
>
> *Our service providers, including our auditors, are expected to be able to rise to the challenge of auditing our complex, global businesses. The barriers to entry for a global audit firm are high and require a certain 'critical mass' to be effective. Current requirements under ISA600: Special Considerations - Audits of Group Financial Statements (including the Work of Component Auditors) require significant input from group auditors which is practically translated as a requirement for group auditors to audit the majority of a group's global subsidiaries. This in turn will preclude smaller firms from competing in the global arena. Therefore our membership will almost exclusively seek an audit from one of the 'Big 4' auditors. The establishment of global networks necessarily takes time and the assembly of a critical mass which we feel would be inappropriate to force."*[127] [emphasis added]

3.30 Our own experience supports the view that an extensive global coverage is absolutely vital to being able to audit large companies. A range of reports and tenders illustrates this requirement:

(a) [✂]: *"International network overseas links work well… Feels that our scale and reach internationally is a big strength."*[128]

(b) [✂]: *"As the group gets more international their reliance on PwC would get ever greater. He was particularly keen to ensure that our audits in the new areas such as [✂] were sufficiently detailed and thorough."*[129]

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127 Hundred Group submission to the House of Lords Economic Affairs Committee, 27 September 2011 at http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10120702.htm.

128 See Exhibit 62: [✂]

(c) [✂]: *"The cultural differences of our globe will necessarily create inconsistency between people within our firm. Therefore it underpins the importance of the group team in creating the common thread throughout PwC audit service"*[130] and *"overseas: well co-ordinated, teams were well briefed and everyone seems to sing to the same song sheet ."*[131]

(d) [✂]: *"Commented on what he saw as a missing point in the current debate about Big 4 dominance that it is only the Big 4 that have the capability to offer consistent service around the world and that businesses such as theirs need that from their service providers."*[132]

3.31 To be credible it is not enough simply to have a presence on the ground in particular locations. The relevant offices must have a sufficient number of skilled people; use the same methodology, IT and communications systems and people supervision structures; and have appropriate sector experience and ancillary skills, such as actuarial or tax specialists. The local office must, to the extent practicable, offer a similar level of reliability and quality to that of the lead office and all other offices in the network. Lack of quality or failure to detect a misstatement in a local office could have as serious a consequence for the effectiveness of the audit and the reputation of the audit firm and network as an equivalent error in the lead office. To the extent that we have experienced difficulties when auditing certain companies in particular locations, this has sometimes contributed to our losing the audit (for example, in the case of [✂], and for [✂]). Thus, the ability of a network to provide a global audit may only be as strong as its weakest link, although the stronger the overall reputation and network, the better it will be able to resist any wider damage arising from localised incidents.

3.32 We would therefore not be in a position to have the confidence to provide a group audit to our clients unless we had confidence in the quality of other PwC member firms. To that end, membership of the network entails that each firm is subject to rigorous quality control systems and processes to identify member firm performance, to identify when changes are needed, and to ensure that PwC network standards are maintained. Furthermore, our partners and staff responsible for the UK parent's audit are in regular contact with, and visit as necessary, the overseas locations to ensure, as far as is practicable, that the audit service is being conducted efficiently.

3.33 Despite PwC's wide international network, it has always been the case that the needs of clients can from time to time influence additions to the network. Most recently [✂] decision to open a new office in that city.

3.34 A global network of firms cannot generally be supported only on the basis of referred work. While the needs of a large company may be the justification for the opening of an overseas office by a PwC firm, the relevant scale and scope of operations to conduct work led out of an office will only typically be economically justified if that local office is also the lead audit office for local companies. This means that the majority of PwC offices around the world are not only focussed on inbound audit work (that is, an

129 See Exhibit 63: [✂]
130 See Exhibit 64: [✂]
131 See Exhibit 65: [✂]
132 See Exhibit 49: [✂]

audit conducted by an office on a company – typically a subsidiary – in support of a group audit engagement led out of another office, often in another country) but also have substantial local audit clients of their own. Without this local practice they are unlikely to have the capability to support the inbound work, such as that required for overseas subsidiaries of FTSE listed companies.

The fifth attribute: Methodology

3.35 To carry out an effective audit there must be consistent methodology across the PwC network. Simply having member firms with some audit expertise across the world is not enough. As the structures of large companies become ever more complex, and the regulatory burden more onerous, so the importance of applying a consistent audit methodology across the network becomes of paramount importance. As [✂] noted, it "*would like to see a standard global format for all information delivered, more consistency across the countries and a structured approach*".[133] This demand is shared by most large companies.[134]

3.36 In response to this demand, the PwC network has developed "Aura", which is a highly tailored audit support tool using bespoke IT software which aims to provide improved application of a single, global, consistent audit approach and methodology.[135] It standardises various processes and assists audit team members to track the progress of the engagement and to check that all work has been completed to a consistently high standard. Aura, as it is fully rolled out, will harness business and professional insights from audits and enable the sharing of these insights across teams and with clients. The system also allows for even greater tailoring to particular industry sectors as part of its future development.

3.37 Total global development costs of the Aura project are estimated to be US$400 million. Of this amount, the contribution from PwC UK is approximately [✂]. The PwC network's central Aura team estimates that in-territory implementation costs across the PwC network of firms are a further US$400 million.

3.38 The software that Aura replaced ("MyClient") functioned largely as an electronic filing cabinet. By contrast, Aura provides a structure and organisation to the audit, whereby the software positively influences the way the audit team approaches and plans the audit. This provides an increased level of engagement and collaboration across the whole team. By electing to proceed with a more sophisticated software tool rather than remaining with a basic filing system, PwC responded not only to the demands of its large clients, but also to the fact that all of its principal competitors were also investing in similarly sophisticated systems.[136]

3.39 Aura is a key part of the Audit Transformation Programme (ATP), which is our global initiative designed to differentiate the PwC audit experience from our competitors and increase our audit efficiency. Another aspect of the ATP is the Global Assurance Delivery Model (GADM), which is a sourcing model that is designed to reallocate

133 See Exhibit 66: [✂]
134 See the examples set out in footnote 68.
135 See Exhibit 67: [✂]
136 [✂] (see Exhibit 68).

certain administrative and common audit procedures to overseas Assurance Delivery Centres in Kolkata, India and Katowice, Poland.[137] The investments required to achieve the long-term vision of creating a network of multi-territory Assurance Delivery Centres are likely to be significant but are essential to us continuing to deliver a high quality and cost competitive audit service. These initiatives are explained in more detail in Annex 6 and are also covered in section 4B below, as a key element in our attempt to distinguish the PwC audit service from that of our competitors.

The sixth attribute: Compliance systems

3.40 We have to comply both with the complex and detailed regulations applicable to the audit of large companies (as summarised in Annex 2), and with our own internal standards and procedures. We have therefore invested in systems to ensure that we comply with requirements relating to client and engagement acceptance, and to support, monitor, review and challenge the quality of our audit work and our independence. These systems are described in more detail in Annex 7. There are around [✂] staff employed full time in the Assurance LoS to provide risk and quality support to audit teams at a direct cost of around [✂] annually, with significant further costs incurred in maintaining and improving the quality of what we do - the main components of which are the time and money spent on training, and the significant network of technical expertise within the business units supporting our audit teams.

3.41 In addition to the risk and quality function within the Assurance LoS, and time spent by the audit team on compliance and risk and quality issues, there are independence and compliance teams separate from the Assurance LoS. The teams are led by the firm's Ethics partner, who reports directly to the Executive Board member for Risk & Quality. The team is responsible for providing appropriate support and processes so that the partners and staff are knowledgeable about independence and similar matters.

C These attributes are required by, and benefit, all large companies including those in the FTSE 250

3.42 The attributes set out above are required and valued, to a greater or lesser extent, by all large companies and not only those in the FTSE 100:

(a) Almost all FTSE 350 companies conduct international business. The chart in paragraph 3.4 above shows the spread of turnover globally of FTSE 350 companies. This illustrates that, for a significant majority of these companies, the need for global capabilities is essential, with the global element constituting the vast majority of the audit in many cases.

(b) In addition to the global aspects, in many cases even the smaller audits within the FTSE 350 involve, for example, highly complex corporate or financing structures requiring the need for specialist expertise to advise on the tax, treasury and actuarial aspects of the audit.

[137] [✂]

(c) The quality and value that a large audit firm can bring are as valued by smaller companies as they are by very large ones. Further, most companies entering the FTSE 350 aspire to grow, often in international markets. Such companies require an audit firm with the knowledge and expertise to support that expansion and to ensure that the financial systems and controls in place as the company expands are fit for purpose relative to their competitors. Indeed, that assurance can be even more important for a company with limited experience of operating a more complex or international business than for one which has many years of accumulated experience to draw on. For example:

(i) When PwC became [✂] audit firm in 2003 [✂] was listed at [✂] in the FTSE 350. At 31 December 2011 it was at [✂]. The tender proposal described what [✂] required from their audit firm:

> *"We are looking for an audit that ensures that we are fully compliant with accounting standards and governance requirements <u>but also</u> one that is constructive, innovative, co-ordinated and efficient. It must go to the heart of the business and the business issues that we face. We want an auditor that brings us ideas and helps [us] meet the challenges that the business faces."*[138] [emphasis added]

(ii) The desire of companies towards the bottom of the FTSE 350 to appoint an audit firm that could help them improve their financial controls and systems in line with the largest companies in the UK is well illustrated by the proposal PwC made to [✂], which was listed at [✂] in the FTSE 350 at the time:

> "*You have told us that you expect us to share observations on how you can enhance controls and improve efficiency. This is particularly critical as you 'raise the bar' across the control environment and finance processes. <u>Our role is to be your 'eyes and ears' and assist you in achieving your vision for your finance processes and controls</u>. This is core to the way we will behave, following our appointment. We will assess your finance function and IT function against what we see as best practice. The results of this will allow you to see how you compare to best practice and help you in your journey to 'raise the bar'. Where we have done this elsewhere, the value has been enormous to the board and the finance team*".[139] [emphasis added]

(iii) That relatively young companies value and demand the benefit of our experience is evident from [✂], which is an unquoted company: *"[✂] is a young company and PwC needs to match its dynamics. Feedback, insights, provocation and challenge need to become an integral part of the service."*[140]

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138 See Exhibit 69: [✂]
139 See Exhibit 70: [✂]
140 See Exhibit 12: [✂]

D Why the mid-tier audit firms are not typically selected by the largest companies

3.43 Much has been made by the OFT and the House of Lords of the inability of mid-tier firms to win the largest audit contracts. In our experience, PwC and the other three largest firms are typically selected to audit large companies because large companies recognise that such firms have developed the attributes necessary to conduct such an audit to a far greater extent than have any of the mid-tier firms. In the following paragraphs we describe how external observers, the AIU and the FRRP, and large companies themselves have viewed the capabilities of the mid-tier firms.

External views of the capabilities of mid-tier firms

3.44 External commentators, including investors, have commented on the relative attributes of the largest and mid-tier firms:

(a) ICGN (the International Corporate Government Network), in its response to the European Commission's green paper on audit dated 14 December 2010: "*Some may argue … that institutional investors should seek to involve smaller audit firms more. This appears to be difficult in practice as the coverage of offices and the expertise and experience in smaller firms are not always sufficient to be able to audit multinational companies*."[141]

(b) CalPERS (the California Public Employees' Retirement System), in its letter to the House of Lords Economic Affairs Committee dated 24 September 2010: "*Today, accounting firms outside the "Big Four" are not competitive with the Big Four in terms of number of personnel, offices and a presence in foreign countries. In essence, much of the consolidation was the direct result of the large accounting firms responding to the need for a presence around the globe, in order to provide global audit coverage required by businesses operating globally.*"[142]

(c) The Hundred Group of Finance Directors, in their letter of 27 September 2011 to the House of Lords: "*Larger auditing firms will, by their nature, have a broader base of experience to draw from when conducting their audits. Our membership represents companies that are fully listed, are acquisitive, raise debt, purchase intellectual property, have complex tax structures and run international treasury functions. These activities require advisors who have a broad background of experience to service us appropriately. In our experience the Big 4 are consistently and comfortably able to deliver the expertise we demand of our auditors and accordingly our members and their shareholders predominantly look to the Big 4 when considering new auditors*."[143]

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141 See Exhibit 71: ICGN consultation letter dated 14 December 2010.

142 See House of Lords, Economic Affairs Committee, *Auditors: Market concentration and their role, Volume II*, Written evidence - Memorandum by the CalPERS, page 13 at http://www.parliament.uk/documents/lords-committees/economic-affairs/auditors/auditorswe.pdf.

143 Hundred Group submission to the House of Lords Economic Affairs Committee, 27 September 2011 at http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10120702.htm.

(d) The US Government Accountability Office, which stated in January 2008: *"Large multinational companies in particular need auditors that have a presence in all of the countries in which they operate. While many midsize and smaller firms partner with other independent firms to expand their geographic reach, a few company officials we interviewed said that most of the international networks these firms belong to are not extensive enough to meet their companies' needs. In addition, many market participants we interviewed were concerned that the quality standards, practices, and internal controls of these networks and affiliations might be less uniform than those prevailing in the international networks of the largest firms."*[144]

(e) Oxera, which noted in its survey of the UK market that 21 of 40 respondents indicated that their main reason for not considering a mid-tier auditor is their lack of international coverage.[145]

(f) The European Commission, in its view on market definition in its decision regarding the merger of Price Waterhouse and Coopers & Lybrand which found that only the largest audit firms could satisfy the requirements of large companies, *"namely to have their audit and accounting services provided by a firm with the necessary reputation in the financial markets (in the case of quoted companies), the geographic breadth to cover their companies needs world-wide (in the case of the multinationals), the depth of expertise in their particular sector (large companies in general and, in particular, regulated sectors such as banking and insurance) and significant resources (all large companies)."*[146]

The view of the Audit Inspection Unit and the FRRP

Audit Inspection Unit

3.45 The AIU's public inspection reports provide an assessment of technical quality to the extent that they assess a firm's policies and procedures to monitor compliance with the regulatory framework, including Auditing Standards, Ethical Standards and Quality Control Standards for auditors as issued by the relevant professional bodies. The AIU report is therefore not an assessment of the overall quality of the service provided to the company, since this would also require - among other things - an assessment of the experience of dealing with the audit team, the nature of the issues raised and discussed, and the commercial value provided.

3.46 The AIU published a public report setting out the principal findings arising from the inspections carried out in respect of firms that audit ten or fewer listed or other major public interest entities on 21 September 2011.[147] (This report does not apply to Grant Thornton or BDO, each of which receives a separate report published every two years. Each of the four largest firms has a separate report published annually.) The AIU reviewed nine listed audit engagements undertaken by such smaller audit firms in

144 See GAO, "Audit of Public Companies", January 2008, page 41 at http://www.gao.gov/new.items/d08163.pdf

145 Oxera Report, page 34.

146 European Commission Decision in Case No IV/M.1016 - *Price Waterhouse/Coopers & Lybrand*, paragraph 32.

147 See Exhibit 72: *"Public Report on the 2010/11 inspections of firms auditing ten or fewer entities within AIU scope"* dated 21 September 2011.

2010/11. The report acknowledges that the diversity of the firms under review makes it difficult to draw inferences about the quality of audit work of all the firms that the AIU inspected. Nevertheless, the report sets out findings on matters that caused the AIU concern.

3.47 The section headed "Key issues and concerns" is set out below:

> *"The key issues and concerns set out below provide an overview of the findings and conclusions arising from our inspections. They are based on findings from inspections at a number of firms.*
>
> - *The number of audits reviewed requiring significant improvement is slightly lower than the prior year but continues to be of concern. …*
> - *The audits of multi-national groups, where the majority of the operations are based and managed outside the UK and audited by other auditors unaffiliated with the group auditor, required significant improvement. …*
> - *Firms should apply appropriate professional scepticism in their work on going concern.*
> - *Reporting to audit committees requires improvement. While reporting must be proportionate to the audited entity, and therefore need not be as comprehensive as at large entities, firms should ensure it is effective. …*
>
> *These findings indicate that <u>where a firm undertakes audits that are commensurate with its level of resources and expertise, it can perform such audits to a good or acceptable standard</u>."* [emphasis added]

3.48 Similarly, the report on the 2009/10 inspections of smaller firms concludes as follows:

> *"At present all firms registered to conduct audit work may accept any audit appointment which they believe they are competent to undertake. Our findings suggest that consideration should be given to establishing specific competency requirements for auditors of listed and major public interest entities in order to reduce the incidence of poor quality audit work."*[148]

3.49 These conclusions demonstrate that to carry out an audit for large companies to the required regulatory standards which is of the requisite technical quality – before considering other factors not examined by the AIU – audit firms require a certain level of resources and expertise. Where the audit firm lacks the resources and expertise required for particular companies, it is less likely to provide an acceptable level of quality.

3.50 The reports for Grant Thornton and BDO are more balanced, recognising in respect of both firms that: *"The firm places much emphasis on its overall systems of quality control and, in our view, has appropriate policies and procedures in place for its size*

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148 See Exhibit 72: *"Public Report on the 2010/11 inspections of firms auditing ten or fewer entities within AIU scope"* dated 22 September 2010, paragraph 1.2.

and the nature of its client base".[149] Grant Thornton is recorded as having five clients in the FTSE 350, and BDO as having four. With some exceptions, these are relatively small companies and less international than many other companies in the FTSE 350. The AIU's findings must therefore be read in context and do not suggest that either firm has the broader attributes necessary to audit the largest FTSE companies.

The Financial Reporting Review Panel

3.51 The FRRP, part of the Financial Reporting Council, seeks to ensure that the provision of financial information by public and large private companies complies with relevant accounting requirements by reviewing large listed and private company accounts. It issues press releases where a company it has reviewed has agreed to revise its accounts or take other corrective action. The press release summarises the issues that have been considered, the directors' explanation and the reasons for the FRRP's conclusion. There have been 17 such press releases since 2005.

3.52 Of these 17 press releases:

(a) five related to audits carried out by the four large audit firms (of which two were in respect of PwC audit clients, although it should be noted that only one of these related to financial statements);[150]

(b) three related to audit clients of Grant Thornton (one) or BDO (two); and

(c) nine related to audit clients of other smaller auditors.

3.53 Bearing in mind that the four largest audit firms have not only significantly more large company clients, but that these are substantially larger and more complex audit clients, the higher ratio of FRRP press releases for the smaller and mid-tier firms is striking. It should be noted that three of the companies to have had a press release have subsequently switched from a smaller auditor to PwC. We also note that of the other companies one has entered administration and one went into receivership (neither of which was a PwC audit client) and one was taken over and is now one of our audit clients.

3.54 The above is consistent with the broader view that: (i) smaller audit firms find it challenging to provide the quality accounting and auditing service required by large companies - or at the least there is a greater risk for companies in appointing a smaller audit firm; and (ii) companies will switch from smaller audit firms to larger ones when they become aware of the risks of using a smaller firm to audit their financial statements.

149 See Exhibits 73 and 74: biannual AIU Public Reports on the 2009/11 inspection of Grant Thornton UK LLP and BDO respectively, both dated 26 July 2011 (section 1.3 in both reports).

150 The other related to the disclosure in the business review of environmental matters, social and community issues and related reputational risk.

How companies view the relative attributes of the largest and the mid-tier audit firms

3.55 On those occasions when the mid-tier firms are invited to tender for the audit of a large company, the feedback available to us suggests that the mid-tier firms, almost invariably, fail to meet the demands of the large company in question. We do not have comprehensive records of tender processes, but to the best of our knowledge there were 121 FTSE 350 tenders between Q2 2001 and Q3 2011 and small or mid-tier firms were only successful in at most a handful of these tenders.

3.56 As Figure 3 below illustrates, and as we explain in more detail in section 4 below:

(a) Of the 130 auditor switches that we have identified for FTSE 350 companies from Q2 2001 to Q3 2011, we believe that there were 12 cases which involved a switch away from a mid-tier auditor acting as sole auditor.[151]

(b) In only three of these cases was another mid-tier auditor appointed, with one of the four large audit firms being successful in the other nine cases. It should be noted that two of the switches between mid-tier firms relate to Grant Thornton's acquisition of Robson Rhodes and previous Robson Rhodes clients deciding to use Grant Thornton after the merger.

(c) In contrast, of the 104 occasions where there was a switch from a large audit firm acting as sole auditor, in only three cases was a mid-tier firm successful.

[151] We distinguish tenders from switches, and our data on switches is likely to be more complete than our data on tenders. Some tenders leading to switches may have been limited to two players (and we may not have been invited), or taken place some time in advance of the actual switch and the decision delayed before implementation (meaning the link between the two is less apparent). Switches following auditor consolidation may also not have involved a tender. We are aware of 121 tenders and 130 switches, although we believe the existing auditor was successful in retaining the audit on competitive tender in only around a fifth of cases. Note that in our analysis, we have recorded switches from Q3 2001 (as this is compared to the position in Q2 2001) whereas market share and other calculations made are from Q2 2001 (i.e. the first data point we have on auditor appointments within our data set).

Figure 3: Switching involving the mid-tier from Q3 2001 to Q3 2011[152]

New auditor \ Old auditor	Large	Joint / Shared	Mid-Tier	Total
Large	101	10	9	120
Joint / Shared		3		3
Mid-tier	3	1	3	7
Total	104	14	12	130

3.57 This is not a matter of companies being unduly influenced by the brand or reputation of the largest audit firms. As will be explained below (in section 5), companies are informed purchasers of audit services. We have seen several examples of companies encouraging mid-tier participation in the tender process and, having had the opportunity to compare the mid-tier with PwC and other large audit firms, deciding that one of the large audit firms offered a better all-round proposition. For example:

(a) [✂]: The company made considerable effort to consider the mid-tier but it concluded after investigation that they were not capable of fulfilling its audit requirements. *"The Audit Committee was keen to explore the mid-tier. [Two of the directors] knew the senior partners of the Big 4 in the region quite well, but didn't know the others. From some local research, they identified five firms and asked for expressions of interest. The response to these requests was variable. Some of the firms responded simply with an annotated email, whilst others took it more seriously and provided a proposal document. From the original selection of five firms, two were shortlisted to go through into the main process. However, one dropped out fairly quickly and the other dropped out immediately before the process kicked off. <u>The exploration of the mid-tier ultimately came to nothing</u> and the proposal process became one of a competition amongst the Big 4."*[153] [emphasis added]

(b) [✂]: [✂] had been a joint auditor prior to the merger that created the company and although [✂] was satisfied with the work that [✂] had carried out in the past, they simply did not have the international coverage necessary to audit the new merged company. The company *"would have loved [✂] to have won it", "they'd done nothing wrong", "fantastic job over the deal", "they had served us for many years"* and the fact that no other major plc had a non-Big Four firm *"wouldn't have stopped me - almost a positive - one of the first."* However, *"It*

[152] Note that reference to "Joint/Shared" in this table includes references to any joint audit (i.e. where two or more auditors sign the opinion) or shared audit (where only one auditor signs the opinion but where another one or more auditors is involved in part of the audit work) arrangement. Note that Andersen is included as a large auditor in this table.

[153] See Exhibit 61: [✂]

was at the presentation that [✂] problems came home to roost. It wasn't about the slickness but about international coverage."[154] [emphasis added]

(c) [✂]: *"[✂] did pitch but [✂] were "amazed" as their audit fee was so high it was felt they must have misunderstood."*[155]

(d) [✂]: The company *"use a couple of mid-tier firms to audit some subsidiaries and that these firms are not as rigorous as PwC. They also appear to come in over budget."*[156]

(e) [✂]: *"The firms below the Big Four were in her words "miles away" in terms of level of service."*[157]

3.58 We note that Mazars' response to the launch of the CC's investigation asserts that it is "*group auditor to five of the 100 largest global companies*"[158] and that it is capable of auditing more large companies. To the best of PwC's knowledge, Mazars has a limited presence outside France compared to the largest firms and it is only involved in audits of five of the top 100 European companies to the extent that it jointly audits (with one or more of the largest audit firms) French companies which are required to have joint audits under French rules. In this context, in those audits where PwC is also involved, Mazars is involved principally in the French domestic and European elements of the audit and their work typically represents around 30% of the total group audit fee. If it were the case that a major obstacle to a mid-tier firm being appointed as sole auditor by larger companies is the lack of experience that the mid-tier have of auditing large companies, then one might expect that Mazars' know-how acquired as a joint auditor of large companies would have enabled it to bid more effectively for sole audit contracts. Its lack of success in this regard suggests that Mazars does not have the other attributes considered by large companies to be of value in a prospective new auditor.

3.59 This is not to say that the mid-tier firms do not offer a quality service to smaller companies who have different requirements from those of larger companies. Quality, and the ability to satisfy the requirements of clients has to be considered in the context of the particular circumstances and needs of the company.

Conclusion

3.60 Providing a high quality, good value audit service to large companies requires the audit firm to possess a wide range of attributes. Not all audit firms possess these attributes. It is recognised by external observers and the market that PwC and the three other large firms have invested over time to develop these attributes and as such are better placed to audit large companies than the mid-tier firms.

154 See Exhibit 75: [✂]
155 See Exhibit 76: [✂]
156 See Exhibit 77: [✂]
157 See Exhibit 2: [✂]
158 See Mazars' submission to the CC of 11 November 2011, paragraph 2.

4 The second pillar: There is competition between the large audit firms

In this section we address the second of our four pillars — the existence of strong competition between the large audit firms for audit work within the FTSE 350. In particular we show:

A That market data shows significant "churn" within the FTSE 350

B How we seek to differentiate ourselves from our competitors through the Audit Transformation Programme

C Our strategy for winning new business

D How our rivals target our clients and how we respond

E [✂]

F How the temporary inability on rare occasions of particular audit firms to act, due to independence restrictions or other conflicts, does not materially reduce competition

4.1 Ian Powell, Chairman and Senior Partner of PwC, explained in our Transparency Report for 2011: *"From a PwC perspective we are clear that this remains a fiercely competitive market. Our clients are sophisticated buyers and they rightly demand continuous quality and performance improvements, which we strive to deliver."*[159]

4.2 This view is shared by independent observers. The highly regarded accounting academics Vivien Beattie, Stella Fearnley and Tony Hines said in their 2011 submission to the House of Lords that "*We have no evidence of lack of competition*"[160], while The Hundred Group of Finance Directors of FTSE 100 companies in September 2010 observed "*We are of the opinion that the services rendered by the 'Big 4' are of a high quality and that there exists sufficient competition in the market place to drive continuous improvement and breadth of choice to our shareholders.*"[161]

4.3 We believe that the existence of vibrant competition between the largest audit firm networks is a characteristic that has been overlooked by both the House of Lords and the OFT, and has not been given sufficient weight in the Issues Statement. While the mid-tier rivals offer only limited competition to the large audit firms (due to their differing business models as set out in section

159 See Exhibit 17: Doing the right thing: Delivering quality audits, 30 September 2011.

160 See paragraph 2.3 of House of Lords Economic Affairs Committee 2nd Report – Auditors: Market Concentration and their role, Volume II (published 30 March 2011), http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10101202.htm.

161 See paragraph 6 of Hundred Group submission to the House of Lords Economic Affairs Committee at http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10120702.htm.

3D above), there is extensive evidence of competition *between* the largest audit firms. When this is taken into account, any concerns around concentration in the large audit sector fall away.

A Competition as shown through market data

Market shares – the need to look beneath the surface

4.4 The Issues Statement highlights high concentration and low switching rates as potential concerns. Such features were highlighted by the OFT in its analysis of market shares within the FTSE 350. The use of market shares in isolation to indicate competitive activity must always be treated with caution. The OFT sought to equate what it believed to be relatively static market shares within the FTSE 100 and FTSE 250 from 2002 to 2010 with a lack of competition between audit firms. However, the OFT failed to take account of the significant change in the composition of the FTSE 350 over time – of the companies comprising the FTSE 350 in Q2 2001, only 167 companies (48%) were still in the FTSE 350 in Q3 2011. This means that each audit firm has had to, and must continue to, compete aggressively even to maintain its share by winning (or continuing to provide) the audit for the significant number of companies which, over time, enter the FTSE 350 and displace those which had previously given the audit firms in question their market shares in the reference market.

4.5 The two diagrams below show how our audit client base within the FTSE 350 has changed over the last ten years.[162] Note that these two diagrams count multiple entries and exits by the same company as only a single entry and/or exit (i.e. there is no double-counting of companies which hover on the edge of the FTSE 350). At Q2 2001 we had 124.33[163] FTSE 350 clients. Between Q2 2001 and Q3 2011 the number of our FTSE 350 audits was boosted by 94.33 audit engagements for companies which entered the FTSE 350 and who were audited by us on entry.[164] We additionally won 26.8 FTSE 350 clients from other auditors over the period. However, 114 companies who were audited by us exited the FTSE 350 (some of whom were previous new entrants). We also lost 23.5 clients to other auditors, leaving us with a total of 108 clients at Q3 2011.[165]

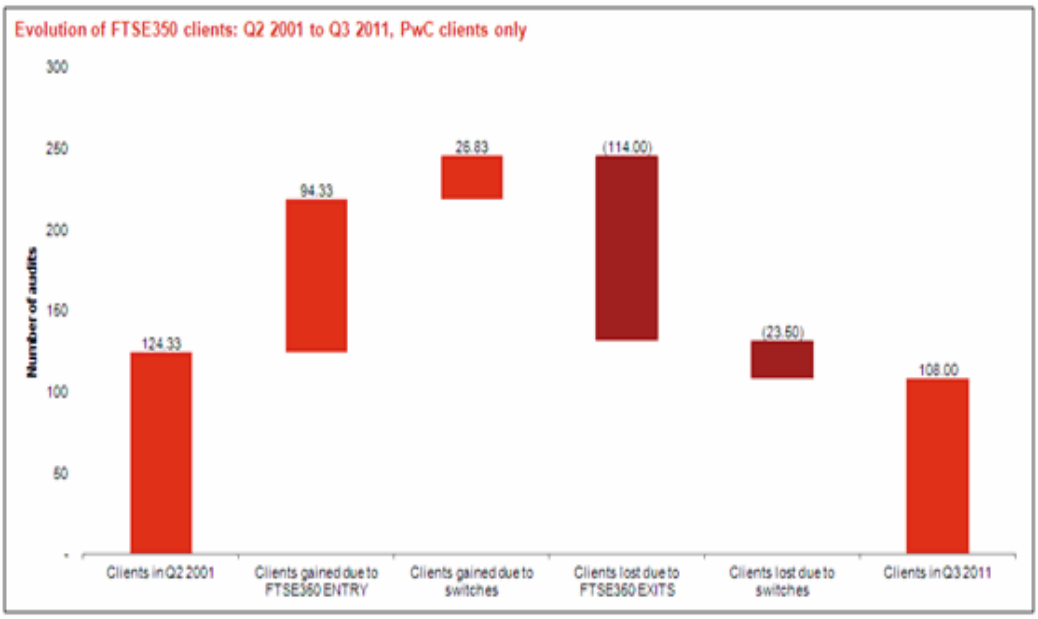
162 Our market share information is taken from a PwC internal database maintained since 2001. This database is updated quarterly with information on the composition of the FTSE 350 from Datastream, and information on the identity of each company's auditor from Hemscott, which we have amended to reflect our best understanding of the market.

163 Where there are two or three auditors of a single FTSE 350 company, we have attributed to each auditor 0.5 or 0.33 of an audit respectively. Note that we believe that many of the situations where companies had multiple auditors in the period we examined were what we refer to as "shared audits" (where one firm signs the audit opinion, but relies on one or more other firms to audit parts of the group) as opposed to true "joint audits" (where more than one firm signs the opinion).

164 Some firms dipped in and out of the FTSE 350 over the period. Where a PwC client enters, exits and then re-enters the FTSE 350 we classify this as a single entry. We follow an analogous approach for exits. The figures therefore are conservative, and could be argued to understate the degree of instability in the reference market.

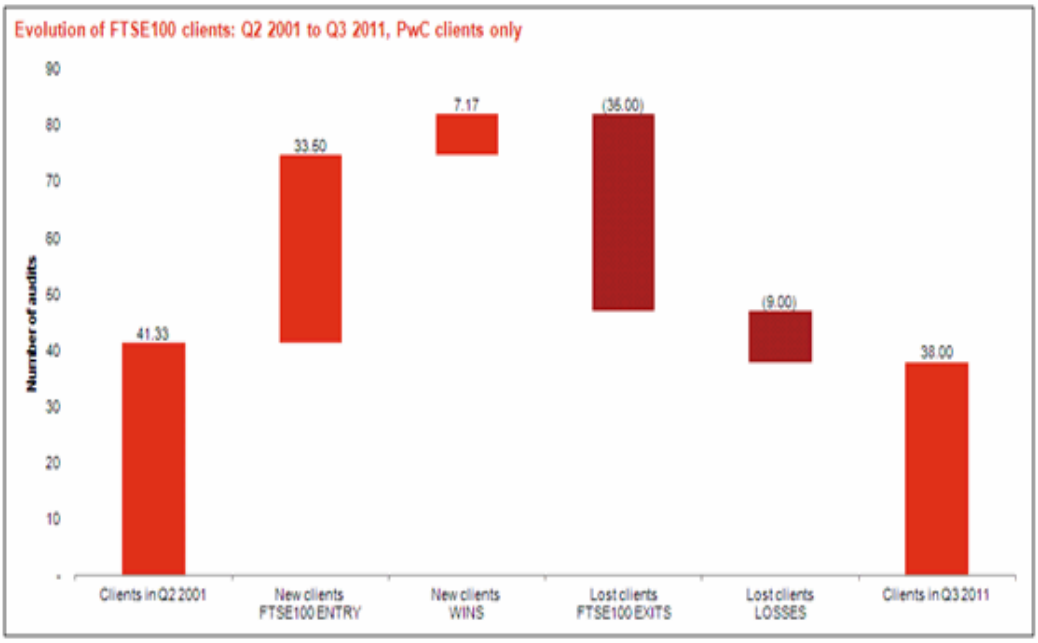
165 Note that some of the clients won and lost by PwC exited the FTSE 350 over the period.

Figure 4: Evolution of market shares: PwC clients in the FTSE 350



4.6 The chart below shows the equivalent position for the FTSE 100, where the apparently relatively static picture of our overall share in Q2 2001 (41.33 audits) and Q3 2011 (38 audits) disguises the fact that during that ten-year period 35 of our audit clients left the FTSE 100 and therefore we needed to hold the audit appointment on 33.5 clients entering the FTSE 100 in order to maintain our overall position. We also lost nine FTSE 100 audits through tenders, but won another 7.2 over the same period.

Figure 5: Evolution of market shares: PwC clients in the FTSE 100



Source: PwC internal data

4.7 As is apparent from these diagrams, we lost a net 13.1% of our FTSE 350 clients over the period (from 124.3 to 108), including due to acquisitions, but this net position disguises far more significant gains and losses:

(a) over the ten year period we lost 137.5 clients from the FTSE 350 through exit from the index and switching to competitors. This is an annual "churn" rate of around 11% of our total client base. Over the ten year period we gained only 121.2 clients – a net loss of 16.3;

(b) only 55 of our FTSE 350 clients in Q2 2001 were in the index and audited by us in Q3 2011 (just over 50% of our total clients in the later period). This means that if we had failed to win any new audit clients within the FTSE 350 or failed to win or retain the audits of new entrants to the FTSE 350 during the ten year period, our market share would have declined to around 16%, compared with our actual share of around 31%;

(c) the story is even more pronounced within the FTSE 100 where 35 of our audit clients exited the FTSE 100 and a further nine switched to another audit firm, a combined total of 44 that exceeds our total client base in either Q2 2001 (41) or Q3 2011 (38).

4.8 Setting aside the "churn" of companies entering and exiting of the FTSE 350, we still lost 23.5 FTSE 350 clients to other auditors over ten years. Of these, 12.5 were companies that we audited in Q2 2001 and 11 were firms that were new entrants to the FTSE 350. If we did not replace these companies by winning tenders or targeting new entrants, our market share would very quickly diminish. Of the 108 FTSE 350 companies we audited in Q3 2011, 53 were either won from rival auditors or were new entrants to the FTSE 350 in the ten year period we looked at. These companies account for nearly half of our Q3 2011 FTSE 350 market clients.

4.9 We believe the picture we have shown for PwC would be similar for the other large audit companies. This is because over the ten year period we looked at more than half of the companies in the FTSE 350 changed between the start and end date, and there was also switching between audit firms. The vibrancy of the market is also demonstrated by the position of Deloitte. Our analysis shows that over the period Q2 2001 to Q3 2011 the number of FTSE 350 audits conducted by Deloitte increased from 45.5 to 89 (driven in part by its acquisition of the Andersen UK business).[166] Its market share has consequently almost doubled from 13% to 25%.

4.10 The charts above illustrate that the large audit firms do not retain market share within a static FTSE 350 in which they simply continue to service long-standing clients. Each of the large audit firms retains or increases market share by: (i) competing to win audits from companies which enter (or appear to have the potential to enter) the FTSE 350; and (ii) winning the audits of companies which switch within the FTSE 350 through tender or otherwise. Without this constant effort to win new audit clients, the market shares of the large audit firms would very quickly decline.

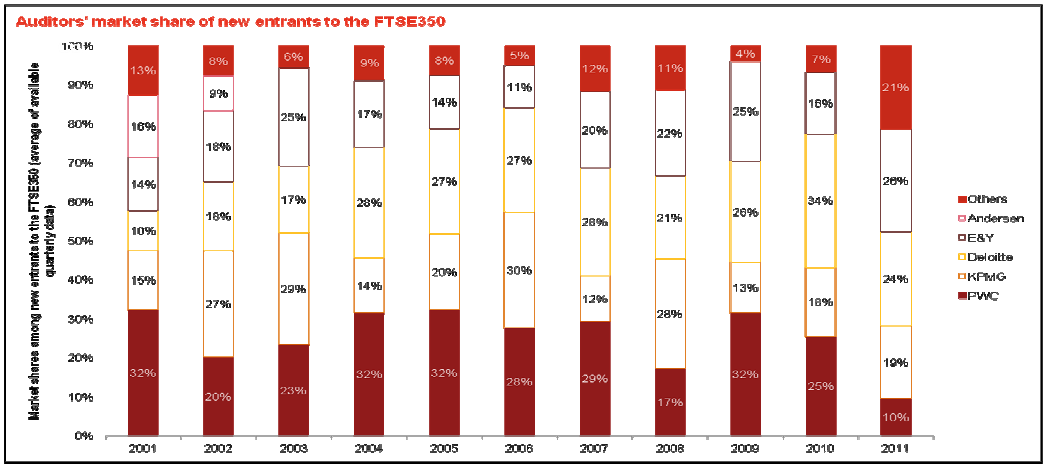
[166] Note that Deloitte's acquisition of the Andersen UK business did not mean Andersen clients switching automatically to Deloitte: only 26 of 32 Andersen sole audit clients in the FTSE 350 listed in our database at the time of its exit switched to Deloitte – i.e., nearly one in five clients chose to switch to an auditor other than Deloitte. Some of the companies that did appoint Deloitte only did so after a competitive tender (we cannot be sure that we are aware of all formal tenders conducted).

4.11 Figure 6 shows the percentage of new entrants to the FTSE 350 which are accounted for by the different audit firms.[167] The key points to note are that:

(a) The percentage of new entrants that are accounted for by PwC varies considerably (fluctuating between 10% and 32% over this period). This shows the dynamic competition that takes place, meaning we face a challenge every year in maintaining or improving our share of companies in the FTSE 350.

(b) On average, over the period shown in Figure 6, the mid-tier firms audited around 9% of companies entering the FTSE 350 but only accounted for an average of 3% of the audits of the FTSE 350. They also audited a far smaller number of companies entering the FTSE 350 than the larger firms (43.5 between all mid-tier firms over ten years, in comparison with 131 for PwC alone). This suggests two main issues preventing the growth of mid-tier auditors: (i) their inability to attract smaller companies which are about to enter the FTSE 350, particularly those that enter and remain in the index for some period of time; and (ii) their inability to retain those companies as they grow and their audit needs evolve.[168]

Figure 6: Audit firm shares of new entrants to the FTSE 350



Source: PwC internal data; Financial Statements from FTSE 350 companies

4.12 As mentioned above, we have attempted to compile a comprehensive database of FTSE 350 switches over the last decade.[169] Figure 7 shows the wins and losses of the large audit firms over the period Q2 2001 to Q3 2011. It also shows the wins and losses of Grant Thornton and

167 Because this figure includes data on other firms' clients, we are less sure of its accuracy. However, we believe that it is accurate to a sufficient degree to evidence the points made in this submission. Note that here all firms entering the FTSE 350 are included, whether or not they had previously entered or exited.

168 It should be noted by comparison that BDO and Grant Thornton have broadly equivalent market shares to the large audit firms amongst AIM listed companies. This shows that the smaller companies at that level do not have the same concern about the abilities of the mid-tier firms to carry out their audits. See Exhibit 78: *[✂]*

169 We have recorded a switch where the auditor in one quarter differs from that in the previous quarter, using data taken from Hemscott. Where a FTSE 350 company acquires a company from outside the FTSE 350 we record a switch of auditor only if the FTSE 350 acquirer changes auditor. Where two FTSE 350 companies merge, we record a switch if there is a change in the auditors of the merged entity compared with the pre-merger entities. For example, if a firm audited by PwC merged with another audited by KPMG, there would be no switch recorded if the merged business appointed PwC and KPMG as shared/joint auditors, but a switch would be recorded for any other situation (e.g. sole PwC, sole KPMG, or different sole or shared/joint auditors).

BDO separately, with the remaining mid-tier auditors reported as a single group (listed as "other"). Shared/joint audits are listed separately, distinguishing shared/joint audits only involving large audit firms and those also involving the mid-tier firms.

4.13 As this table demonstrates, switching by companies in the FTSE 350 is largely between the large audit firms. For example, during the period Q2 2001 to Q3 2011, 120 of the 130 switches (92%) were won by a large auditor (including one by Arthur Andersen before its exit), with a further three won by shared/joint auditors of whom at least one was a large audit firm. Only seven FTSE 350 companies switched to a mid-tier firm. Of those, only three were switches from a large firm to a mid-tier firm.

4.14 We lost 21 sole audits during the period with a further five shared/joint losses.[170] Had we not competed effectively to win tenders, then the losses would have significantly reduced our share within the FTSE 350.[171]

Figure 7: Wins and losses of FTSE 350 audit contracts Q3 2001 to Q3 2011

New auditor \ Old auditor	PwC	KPMG	Deloitte	E&Y	Andersen	BDO	Grant Thornton	Other mid tier	Joint audits: Big	Joint audits: Big	
PwC	-	7	8	6	2	1	1	0	3	0	28
KPMG	5	-	2	5	2	0	0	2	3	0	19
Deloitte	10	8	-	6	26	1	1	1	3	1	57
E&Y	4	3	3	-	3	1	0	1	0	0	15
Andersen	0	0	0	1	-	0	0	0	0	0	1
BDO	1	1	0	0	0	-	0	1	0	0	3
Grant Thornton	0	0	0	0	0	0	-	2	0	0	2
Other mid tier auditors	1	0	0	0	0	0	0	0	0	1	2
Joint audits: Big four	0	0	0	0	0	0	0	0	1	0	1
Joint audits: Big four and mid tier	0	0	0	0	0	0	0	0	0	2	2
	21	19	13	18	33	3	2	7	10	4	130

Source: PwC, Financial Statements from FTSE 350 companies

4.15 Much of the material that follows describes our initiatives to try and win audit business from our rivals and to retain our existing clients. We are of course aware that our competitors have their own competitive strategies and we provide details of how we respond to these, in part by seeking to monitor clients' concerns and our own performance in order to ensure we are best able to respond to any issues, thereby minimising the risk of losing our clients. While we focus on our own position in the following sections, the CC will of course look more broadly at the

170 This is equivalent to 2.5 audits using our approach.

171 It should of course be appreciated that fierce competition can produce stable market shares where firms win customers from each other in equal proportion. As Figure 7 shows, PwC has won seven, eight and six audits from KPMG, Deloitte and E&Y respectively, while losing five, ten and four to the same competitors. The competition for these audits is not apparent from market share analysis which will show the position between the firms being relatively stable.

competitive dynamic between the firms and how this dynamic is influenced by their various strategies and actions.

Switching levels

4.16 As we explain in section 5, levels of tendering and switching are not a good indicator of competitive activity in this market, and as shown above, there is in any event significant competition through "churn" in the FTSE 350. Below we address the low level of switching highlighted by the OFT and some issues with the OFT's methodology. In summary, the levels of switching identified by the OFT in its decision do not present the full picture.

4.17 The OFT's approach is to examine switches by companies that were in the FTSE 350 at June 2011. Using FAME data, the OFT finds that collectively these companies switched on 86 occasions over the period 2002 to 2010[172] (17 among FTSE 100 companies, and 69 among FTSE 250 companies). The OFT uses these switches to calculate annual switching rates and average switching frequencies.

4.18 However, the OFT's methodology is misleading. A reasonable interpretation of what is meant by the "average annual switching rates" for FTSE 350 companies over the period 2002 to 2010 would be the proportion of companies within the FTSE 350 over that period that switched on average each year. This is not what the OFT reports. Whilst it is not fully clear what the OFT has done, it appears to:

(a) ignore switches by companies which were in the FTSE 350 for all or part of the period between 2002 and 2010 but which were not in the FTSE 350 in June 2011;

(b) include switches by companies which were in the FTSE 350 in June 2011 but which were not in the FTSE indices at some point between 2002 and 2010;[173]

(c) ignore switches where FAME data is not available;[174]

(d) ignore switches associated with Deloitte's acquisition of Andersen's UK business; and[175]

(e) generally ignore switches involving shared/joint auditors.[176]

4.19 For the reasons above, in our view both the methodology and the FAME data set are inadequate for the purpose of estimating the number of switches. To understand how much switching took place in the FTSE 350 over the recent past, which is what the OFT purports to show, we believe that it is necessary to look at the FTSE 350 on a rolling basis, examining switches amongst those companies that made up the FTSE 350 at each point in time. This

172 This number of total switches is the sum of the switches in the FTSE 100 and FTSE 250 identified by the OFT.

173 In footnote 55 of the OFT's Market Investigation Reference, the OFT notes that it does not include switches of firms in its sample that *"left the FTSE indexes"*. It is not clear whether the OFT is referring to the FTSE 100/250 indices or the FTSE All Share index. We anticipated that the OFT would wish to exclude switching by companies after they leave the FTSE 350 index. However, the relatively large number of observations it reports for 2002 (232 compared to only 289 in 2010) suggests that the OFT may have included switching which took place when the companies exited the FTSE 350 but remained in the FTSE All Share index (presumably because this is what the FAME database attempts to capture).

174 Even for 2010, the OFT reports on only 289 out of a maximum of 350 companies.

175 In our view these switches should be included, as companies were not obliged to be audited by Deloitte and some chose other auditors or choose Deloitte only after a tender (see footnote 165 above).

176 FAME only records a single auditor for each company. Changes involving shared/joint audits are not generally recorded as switches by FAME except where FAME reports a change in the leading auditor.

avoids the sample of companies diminishing over time looking backwards as companies recently in the index are found not to be present in the FTSE 350 historically. It also ensures that switches which took place while companies were outside the FTSE 350 are not included (notwithstanding that capturing switching levels for companies just outside the FTSE 350 that later enter that index is important to understand the full extent of competition to audit large companies as explained above).

4.20 We utilised the data set described in footnote 161 above. The switches within that data set were checked by a team of forensic accountants using information from company annual reports. In our view this data set is both more complete than FAME - we have obtained details of all companies which were in the FTSE 350 between Q2 2001 and Q3 2011 - and, in our view, more accurate.[177] The data set also allows us to examine switches involving shared/joint as well as single audits.[178]

4.21 Our analysis of this data set found a total of 130 switches by companies which were in the FTSE 350 between Q2 2001 and Q3 2011. This is significantly higher than the OFT's 86 switches, although our estimated switching rate, 3.6%, is similar to the OFT's estimate of 3.5%.[179]

4.22 The importance of this is that the number of switches in the FTSE 350 was significantly higher than the OFT suggests in Tables 1 and 2 of its decision – in fact there were over 50% more total switches. Within the FTSE 350 index, which necessarily has a finite number of members, this higher number of total switches represents a significant increase in competitive opportunities for audit firms than the OFT analysis suggests.

4.23 As discussed further in section 5 below, companies do not need to resort to full competitive tenders in order to exert competitive pressure on their auditors. The threat to tender gives them significant leverage in negotiations. In looking at full competitive tenders, we have identified 121 in the ten year period to Q3 2011.[180] This number must be the minimum number of tenders in this period as we know that these took place, but there may be others of which we are not aware. Of these 121 tenders, the existing auditor retained the audit on just 29 occasions - which is just 24% of cases. The reason for this relatively low retention rate for the existing firm is that tenders are often triggered by client dissatisfaction. Consequently, auditors strive to provide a high quality and good value service and must respond to the pressure exerted by companies in negotiations to avoid tenders.

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177 We have found a high proportion of errors in the FAME database, with 33% of audit fee entries in a sample of FAME entries we examined showing significant inaccuracies. While we recognise our database may not be perfect, for example, due to tenders taking place which we were not aware of, we believe it is considerably more accurate than FAME.

178 For shared/joint audits, as noted above, we have treated each audit firm as having 0.5 of the audit where there are two audit firms appointed and 0.33 where there are three firms appointed.

179 The main reason why our total number of switches is so much larger than the OFT's despite only a marginally higher switching rate is that the OFT has considerably fewer observations, both because the OFT has a shorter time frame (9 years, compared to our 10), due to the OFT's methodological approach of using only companies in the FTSE 350 at June 2011, and because of missing observations in the FAME database. Our approach is to review FTE 350 entries on a quarterly basis throughout the period Q2 2001 to Q3 2011, and record any switch that occurs while a company is within the FTSE 350.

180 This number must be the minimum number of tenders in this period as we know that these took place, but there may be others of which we are not aware.

B How we seek to differentiate our audit service - the Audit Transformation Programme

4.24 We have a strategy to win new audit business including from large companies. We also face a challenge in retaining business given competition from strong rivals and changes in our target market, for example due to mergers and acquisitions. We thus strive continually to improve our service in its various aspects (as discussed in section 3) and innovate to find creative solutions to the often highly complex issues faced by clients. The views of existing and prospective clients are of critical importance in this regard, which is why we invest considerable resources in our client feedback programmes.

4.25 The Audit Transformation Programme (ATP) was launched in April 2006 as a major innovation to seek to differentiate the PwC audit service across the world. It was described by Don McGovern, the Global Assurance Leader of the PwC network of firms, as "*a critical element of the Global Assurance strategy and is essential to the quality, competitiveness and growth of the Assurance business across the Network* [representing] *a once in a generation opportunity to transform assurance practices across the network to meet the needs of our clients, our people and our network.*"[181]

4.26 As the ATP has progressed, it has become clear that to succeed with the goal of transformation to a distinctive audit offering, a balance is required across mutually reinforcing initiatives designed to increase quality, efficiency and value for clients. The ATP is described in detail in Annex 6.

4.27 The vision for the ATP focuses on combining people, processes and technology to achieve five objectives:

(a) the delivery of consistently high quality audits;

(b) an increase in productivity and reduction in costs;

(c) the enabling of a more rewarding experience for our people;

(d) the facilitation of organisational learning; and

(e) the provision of a distinctive service to clients.

4.28 It is recognised that no single element alone can achieve the transformation that we are seeking through the ATP. The combination of changes necessary consists of three key elements, which are being rolled out by the Assurance LoS across the international network:

(a) Audit tools and methodologies: This is principally focussed on Aura.

(b) Delivery models: This considers by whom and where the audit work should be carried out including through the Global Assurance Delivery Programme (GADM).

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181 See Exhibit 79: [✂]

(c) Behaviours: This focuses on changing the working practices of the firm, delivering the PwC Experience (a global initiative) and Value without Compromise (a UK initiative).

C Our strategy for winning new business

4.29 We go to great lengths to ensure that our audit clients remain satisfied with their service and therefore do not feel the need to put the audit out to tender. However, as shown above, merely retaining those audit clients is not enough to retain our market position. We have the ambition to grow the audit practice and we believe, based on what we see in the market place and what we read in their public pronouncements, that all three of the other large audit firms have the same ambition.[182] Given this dynamic market, and uncertainty about who the large companies of the future will be, as well as the challenge of winning new clients, an active targeting programme is a necessity.

4.30 We have a number of initiatives in this area:

Tanks on Lawns

4.31 In July 2007 we started a targeting programme called "Tanks on Lawns". This involved targeting the audits of a small number of high-profile companies with the aim of growing the audit practice through winning "brand-defining" audit clients. The Tanks on Lawns programme clearly asserted the importance of, and the commitment to grow, our core audit practice.[183]

4.32 The Tanks on Lawns targets were selected using the following criteria:

(a) being a FTSE 100 company;

(b) the probability of a tender occurring in the next three years being above 50%; and

(c) the probability of us winning the tender being above 40%.

4.33 Tanks on Lawns recognised that sustained investment in building relationships and understanding the target's business and the issues it faced was necessary to position ourselves to attempt to win the audit of any of these target clients. The 2009 status report[184] indicated that the clients being targeted at that time were [✂]. Of these we won the tender for the [✂] audit,

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182 See for example the following quotations:
KPMG: *"We are eager to increase our collective share of the audit market. Growth here always takes patience; our established long track record of high quality performance while serving a diverse range of clients is helping us to achieve this."* (KPMG Europe LLP Annual Report 2010, page 4, http://www.kpmg.com/EU/en/Documents/annual-report-ellp-2010.pdf).
Deloitte: *"Deloitte's four-year strategy aims to build our competitive edge through a combination of organic and inorganic growth, and to focus our investment particularly in those areas where we see the strongest opportunities for growth in client relationships and distinctive positioning. This strategic choice will give us the best opportunity to grow faster than the market."* (Deloitte 2011 Annual Report, page 9, (http://annualreport.deloitte.co.uk/2011).
Ernst & Young: *"We've won some well-known audit clients over the past couple of years, many of whom have cited our globalised structure and focus on traditional services as a key factor in their decision to appoint us."* (EY website, Chairman's Q&A) (http://www.ey.com/GL/en/About-us/Our-global-approach/Global-review/Global-review-2010---Chairman-s-Q-A).

183 The Assurance Executive regularly assesses the progress with regard to top tier targets and wins. [✂]

184 See Exhibit 80: [✂]

and won [✂] audit [✂]. In December 2009, the initiative was also rolled out to FTSE 350 companies.[185]

4.34 The initiative required the lead Assurance partner for each target to establish a "shadow team" to assess the opportunity, develop a targeting plan, and ensure an appropriate degree of readiness in anticipation of an audit tender. It required the target team to establish or capitalise on relationships that existed with the company, demonstrate the firm's capabilities in the UK and overseas, and to try to prompt a tender. For instance, clients were assessed based on whether we (or other PwC network firms) had developed relationships with global executives and non-executive directors and whether we provided non-audit services. Target teams reported progress to Assurance Management regularly. A successful example of the use of the "shadow team" was in relation to [✂] where the deployment of the shadow team and the relationships they developed culminated in our winning the audit tender in Autumn 2010.

Mid-cap programme

4.35 In January 2009, we also increased our targeting efforts in the mid-cap sector,[186] particularly in London where our market share was relatively low. We did this by moving partners and staff to our London Mid Tier (LMT) business unit and formalising and monitoring more vigorously its sales pipeline, as evidenced by the LMT "sales funnel".[187] Since that time LMT has been successful in winning 14 new listed audits.[188]

Velocity

4.36 In October 2008, we started Velocity,[189] a programme designed to improve, standardise and sustain the relationship and sales skills of our people. Velocity was commissioned as we recognised that if we maintained our growth trajectory at that time, we would be overtaken by Deloitte as the leading firm in the UK.

"Net 635"

4.37 From Autumn 2010 onwards, Tanks on Lawns was superseded by a new targeting initiative across the audit practice which has become known as "Net 635".[190] The objective of this initiative is to achieve an increase in audit revenues from new clients by [✂] to 30 June 2012, which is estimated to equate to [✂]. Although this objective is across the Assurance LoS as a whole, companies within the FTSE 350 are included within the target – [✂]

4.38 "Net 635" was initiated in recognition that it was necessary to win new clients across a broad spectrum of scale, sector and location, and if we did not do this we would not achieve our growth objectives.[191] In terms of progress to date:

(a) In financial year 2011, we won [✂] audits with a value of [✂]. This leaves a target for financial year 2012 of [✂] audits with a value of [✂].

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185 See Exhibit 82: [✂] Exhibit 83: [✂]
186 Being those companies in the FTSE All Share and in the AIM (Alternative Investment Market).
187 See Exhibit 84: [✂]
188 The Assurance Executive conducts regular assessments of its targets and wins in the mid tier. See Exhibit 85: [✂]
189 See Exhibit 88: [✂]; and Exhibit 89: [✂]
190 See Exhibit 90: [✂]; Exhibit 91: [✂]
191 See Exhibit 93: [✂]

(b) Significant wins within the FTSE 350 in 2010/2011 included Aviva from Ernst & Young and TUI Travel from KPMG (both FTSE 100 companies); and IG Group Holdings from Ernst & Young (a FTSE 250 company).

(c) However, we failed to win a number of audit tenders where we were trying to replace the existing auditor, including that for [✂] (a FTSE 100 company); and [✂] (all FTSE 250 companies).

(d) During 2010/2011, we also won tenders for significant clients including Burberry (a FTSE 100 company), Capital & Counties Properties and Shaftesbury (both FTSE 250 companies). These were all existing PwC audit clients (i.e. we retained the audit appointment on tender), so these were not included in the [✂] net "wins".

(e) In London, the success of the initiative has led to us overtaking Deloitte as having the largest number of audits in the capital.[192]

4.39 The October 2011 update on "Net 635" noted challenges for the rest of this financial year and beyond.

(a) If the increase in the number of tenders in the FTSE 350 continued (there were nine FTSE 100 tenders in financial year 2011), we recognised that we had to be ready to be involved in more tenders. Action was commenced to improve our tendering capabilities, including the development of more standardised proposal documentation, more flexible proposals support (such as third party presentation coaches and targeted business development resources) and better use of proposal delivery technology (including electronic presentations and dedicated websites).

(b) To achieve the target of net audit wins, the focus on maintaining high quality to retain clients was recognised as key. In this respect, as well as constantly maintaining and improving the quality, value and efficiency of our audit service (including through the ATP as explained in paragraph 4.25 above), we explain in paragraph 4.44 below our efforts to monitor client feedback, including through the new Audit Relationship Risk Diagnostic.

(c) A selected list of companies within the FTSE 350 has been identified for targeting by a "shadow team", which is monitored regularly by the Assurance Executive. Targets currently include: [✂].

D Competitive targeting by our competitors and how we respond

4.40 In the following paragraphs we explain how our competitors target companies we audit; describe the major risk factors we face in this regard and describe how we seek to respond to such threats.

Examples of targeting by our competitors

4.41 We are aware of constant attempts by our rivals to win our clients' audits and as the switching data demonstrates (see Figure 4 above) we have lost on average over two of our FTSE 350

[192] See Exhibit 94: [✂]

clients per year due to switches. While this is an on-going process – much of which is, for obvious reasons, not immediately apparent to us – there are occasions when we become aware of specific attempts to target particular audit clients for example by rivals that shadow our audit teams. Typically this is from intelligence provided by the company management themselves in order to exert competitive pressure on us.

4.42 In most cases we hear of such targeting by word of mouth and some specific examples which have been recorded are set out below:

(a) [✂]: "*All 4 firms are 'at the door' with their best advisers*."[193]

(b) [✂]: *"[✂] would love the audit", "[✂] and [✂] are forever 'circling' [✂]"*[194] and *"competition is strong and other Big Four firms and consultancies are hungry to win work."*[195]

(c) [✂]: The head of financial control told us that he was *"very aware of [✂] retail credentials and that [✂] invest a lot of time in building a relationship with him despite not being rewarded with much work".*[196]

(d) [✂]: *"[✂] has always done a great job at building relationship, wheedling their way in to clients, finding ways of doing work,"*[197] and [✂] "*got a 'foot in the door' on due diligence because they were more proactive and creative than PwC (and offered to do an acquisition for free and thereby proved themselves)*".[198]

(e) [✂]: "*[✂] are active in trying to position themselves should [a tender] happen.*"[199]

4.43 Competitors might make "cold" offers to our audit clients to provide the audit at lower fees (the existing fee being completely transparent in the Annual Report), to seek to initiate audit tenders. We have experienced this at a range of large companies in recent months (including [✂] and [✂], where the CFO reported "*offers from other Big 4 - he said at least two of them - to do the audit for half our current fee.*"[200])

The major risks

4.44 In the face of these threats, we go to great lengths to ensure that the large companies we audit are satisfied with the quality, efficiency and value of our service. We monitor our clients extremely closely in order to be able to react to any emerging client dissatisfaction with the audit service. The processes utilised for this purpose, such as CPRs, ISPRs and CSSs, are outlined in paragraph 2.67 above.

4.45 To improve our procedures for monitoring whether we are doing all we can to see off the competitive threats to our existing audit appointments, in 2010[201] we introduced a client

193 See Exhibit 3: [✂]
194 See Exhibit 95: [✂]
195 See Exhibit 9: [✂]
196 See Exhibit 96: [✂]
197 See Exhibit 32: [✂]
198 See Exhibit 97: [✂]
199 See Exhibit 4: [✂]
200 See Exhibit 98: [✂]
201 PwC was conducting similar assessments before this time as well. See [✂]

feedback process requiring lead audit partners to complete annually an Audit Relationship Risk Diagnostic[202] for our FTSE 350 clients. [✂]

(a) [✂][203]

(b) [✂][204]

Figure 8: [✂]

(c) [✂]

(d) Although competitor activity is a separate risk category, it is apparent that the existence of strong, capable competitors able and willing to take competitive advantage of any perceived weaknesses in our client relationship heightens the risk in all of the risk categories.

(e) In total, and based on the lead partners' perspective, [✂] of the companies we audit were judged to be subject to high or medium risk factors, being the sum of red and amber total gross risk scores [✂].

How we respond to the risks

4.46 We strive to respond to the feedback we receive from existing clients by focusing on service delivery, value and price, so as to avoid or at least reduce the chances of the relationship breaking down.[205] The CPRs are collated and reviewed every year and the key findings are analysed to ensure that lessons are learned and efforts are made to improve our service.[206] Some examples of where we have been recognised by companies as having responded to concerns raised in the past include the following:

(a) [✂]: *"PwC has responded well to the feedback from last year and relationships have moved to 'another level";*[207]

(b) [✂]: "*…if we hadn't exceeded their expectations we'd have almost certainly lost the job",*[208] *"pleased PwC had looked seriously at their concerns over fee and approach... felt we had responded appropriately."*[209]

(c) [✂]: *"There has been significant improvement in the relationship between PwC and Central IT following last year's feedback". "It's tremendously improved from last year - the lines of communication are now open."*[210]

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202 See Exhibit 99: [✂]
203 [✂] see Exhibit 100: [✂]
204 [✂] See also Exhibit 102: [✂]
205 [✂]
206 See Exhibit 103: [✂]
207 See Exhibit 105: [✂]
208 See Exhibit 106: [✂]
209 See Exhibit 107: [✂]
210 See Exhibit 108: [✂]

(d) [✂]: "*There has been very positive reaction to all the changes that were made in 2007 (as a result of feedback received last year).*"[211] [✂]

4.47 This evidence demonstrates how we are active in developing and maintaining strong long term relationships with our large company audit clients. There are significant mutual benefits for both the company and the audit firm of building a long term relationship. The better an audit firm knows the company's business, the more likely it is that the audit firm will be able to provide a high quality audit service: risks and difficult judgements can be identified and resolved more efficiently; the prospect of spotting fraud is enhanced; the audit firm is well-placed to support the company in the audit aspects of the integration of any new businesses or expansion into new countries; and generally it can provide valuable independent insight to management and the directors.

4.48 However, we recognise that to succeed in developing a long-term relationship requires us to deliver a consistently high standard of service, which is recognised as providing good value for money. Only then can we expect to be re-appointed. The following comments illustrate this:

(a) [✂]: *"Once you are in, you are there for a long time, <u>if you perform</u>."*[212]

(b) [✂]: *"<u>It isn't broken</u> so don't fix it"*[213] (although as noted above, we later lost this audit [✂]).

(c) [✂]: *"cannot see any reason why there would be an audit tender in the near future. <u>The only things he could see forcing an audit proposal would be fees or quality of service</u> and these are both where he would expect them to be at the moment."*[214]

[emphasis added]

E [✂]

4.49 In the following paragraphs we explain that the impact of independence restrictions on the non-audit work that we may carry out for audit clients does not prevent or deter us from identifying and pursuing non-audit clients to become the auditor, and we demonstrate how we actively target a number of companies for audit work. We describe the range of factors that influence our marketing strategy. We also explain why there is generally no financial disincentive to seeking audit work from non-audit clients.

[✂]

4.50 [✂]

4.51 [✂][215] [216]

4.52 [✂][217]

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211 See Exhibit 25: [✂]
212 See Exhibit 109: [✂]
213 See Exhibit 110: [✂]
214 See Exhibit 111: [✂]
215 See Exhibit 112: [✂]; Exhibit 113: [✂]; and Exhibit 114: [✂]
216 See Exhibits 112, 113 and 114: [✂]

[✂]

4.53 [✂]

4.54 [✂][218]

4.55 [✂]

4.56 [✂][219 220 221 222]

4.57 [✂]

Figure 9: [✂][223 224]

F Large companies have real choice when selecting their audit firm

4.58 Exceptionally, there are situations where companies may feel that their choice is less than four (for a variety of reasons, some of which are set out below), but the frequency of this should not be overstated. All large companies have a choice of audit firm with many selecting only three firms when going to tender and some quickly reducing the field to two firms for the final stages of the tender process. Given that Bertrand competition theory makes clear that, in the context of a competitive tender process, two suppliers is enough to ensure that the customer receives a competitive offer, it is not surprising that large companies often focus attention on the two strongest suppliers when carrying out tenders. In the following paragraphs we explain why independence rules, sector expertise and commercial conflicts do not deprive companies of an effective number of audit firms available to ensure effective competition.

Where independence restrictions apply

4.59 As described in paragraph 4.52(c) above, there are only [✂] companies in the FTSE 350 where we would be prevented by independence restrictions from carrying out the audit. For other [✂] companies where there might be an independence issue in the short-term, were we requested to do so by the company there are very few where we would be unable to "cleanse" ourselves of independence concerns if required. Our ability to do this was amply demonstrated in the recent case of [✂].

4.60 The strengthening of independence rules and internal policies in recent years may have helped to widen choice because large companies typically now have strong relationships with several, if not all, of the four large firms as well as some mid-tier firms, as they diversify their supply of the various audit and non-audit services. We believe that all large companies will have dealings with at least two of the four largest audit firms. As a result, they know each audit firm's generic

217 [✂]
218 Exhibit 112: [✂]; Exhibit 113: [✂]; and Exhibit 114: [✂]
219 [✂] Exhibit 112: [✂]; Exhibit 113: [✂]; and Exhibit 114: [✂]
220 See Exhibit 112: [✂]
221 See Exhibit 114: [✂]
222 See Exhibit 112: [✂]
223 [✂]
224 [✂]

strengths and weaknesses, and delivery of highly regarded non-audit work is often an avenue leading to being invited to tender for the audit work (as recognised by our Tanks on Lawns initiative).[225] In making their decisions on non-audit service providers, companies keep under review the need to have sufficient choice of auditors.

Expertise in a particular industry sector

4.61 In a limited number of sectors (banking, mining and utilities were noted by the OFT), the complexity of the sector means that a relatively high degree of industry knowledge and specialist expertise is required for the audit firm to be capable of providing a high quality audit service. These are among the most complex companies to audit and where the attributes of the largest audit firms are really put to the test.

4.62 The fact that not every audit firm currently has the expertise necessary to put forward the most credible bid to audit every large company emphasises the importance of audit firms investing over a substantial period in the right people and network and developing the necessary high levels of industry knowledge and expertise. The choice remaining for the company is of those audit firms with a very high degree of expertise.

4.63 Even though a particular large audit firm may not at present be auditing a large company in a specific industry sector, it is likely to be perfectly capable of offering a competitive service in that sector if an opportunity arose. The audit firm would be equipped to do this for the following reasons:

(a) It has experience of auditing large companies.

(b) While it may not audit a large UK listed company in the given sector, other member firms in the same network may audit a large company in that sector that is listed elsewhere in the world. Partners and staff in the international network with specific sector expertise are often deployed to strengthen local territory capabilities. For example, within the PwC network, UK and US partners lead the audits of large Swiss insurance companies; UK partners work on financial services audits in Japan; a US partner leads our work on a Russian energy company; UK and US partners lead, or have led, a pharmaceutical audit in Switzerland; and PwC US has provided partners to lead a large multinational audit in Finland. A further example is the transfer of an oil industry partner based in Houston from the US firm to the UK firm to lead the [✂] worldwide audit, which involved that partner undertaking the ICAEW professional exams in order to qualify in the UK.

(c) The firm may audit smaller or non-listed UK companies in the given sector.

(d) The UK firm may audit UK subsidiaries of companies in the relevant sector where the lead firm is another member of the network. This ensures that UK staff and partners have the sector experience.

4.64 The ability of large audit firms to compete in all sectors is illustrated by the following:

[225] [✂] (see Exhibit 80).

(a) Although Ernst & Young currently does not audit any of the listed high street banks in the FTSE 350, it nevertheless carries out significant audit work for major multinational banks listed in the US and in Europe, which requires it to audit the UK subsidiaries of these companies. Ernst & Young also audits, for example, Investec, a leading specialist bank and fund in the FTSE 100. This provides Ernst & Young with audit experience of financial services in the UK, which could be supplemented by involving lead partners from elsewhere in their network as necessary to act on a major high street bank audit should the opportunity arise. It means that even though Ernst & Young remains the only one of the four largest audit firms not currently auditing a leading UK high street bank, it would be able to do so with some investment and focus, and it is certainly the best-placed auditor to win such an appointment if a company preferred an auditor outside the other three large audit firms. Indeed, we are aware that Ernst & Young has a "shadow" audit team in place targeting Lloyds Banking Group.

(b) Historically, Deloitte had limited UK banking or insurance audit practice, but built these up through RBS and Abbey on the banking side and through RBS and RSA on the insurance side. Through these investments Deloitte has become a much more credible bidder for other audit tenders in these specialist sectors.

4.65 The evidence we have shows that our profitability in relation to particular sectors requiring specialist knowledge is no higher than in other sectors, indicating that conditions of competition in those sectors are no different from those in less specialised sectors (see section 6 below).

Commercial conflicts

4.66 There is no legal or ethical restriction on acting as auditor to two or more competing companies. There are many examples of companies which are fierce competitors in a sector but where we act as audit firm for two or more such competitors in a sector. For example:

- Barclays, Lloyds and Nationwide;
- Tesco, J Sainsbury, Waitrose and Marks & Spencer;
- Shell and ExxonMobil;
- BAT and Imperial Tobacco Group; and
- Thomas Cook and TUI Travel.

4.67 To the extent that certain companies choose not to appoint the same audit firm as that employed by their closest competitor, this is the commercial decision of the company involved and the practice varies across sectors. In reality, commercial conflicts are an issue for only a limited number of companies in the UK. Furthermore, the examples above demonstrate that it is possible for fierce rivals to use the same audit firm. We believe that if a company that currently prefers not to use a rival's auditor became dissatisfied with its current auditor, it could alter this preference should that be perceived as necessary.

4.68 For most industries, however, companies appreciate that a firm auditing a number of companies in the sector gives that audit firm a competitive edge, to the extent that it has greater industry

knowledge and the ability to offer focussed and valuable insight. In our experience, company management and audit committees (who have themselves extensive experience of the various audit firms, as will be discussed in section 5 below) understand the trade-off between sector expertise and commercial sensitivities and are well able to make informed choices. The large audit firms' ability to rotate partners and staff across clients in and across sectors also gives them more flexibility to meet clients' needs.

4.69 In the event that an existing large audit client expressed a strong view that we should not tender for the audit of a competitor, we would of course have regard to those concerns. Even in the very unusual situation where we were to decide in such a context not to tender we believe every company would still have sufficient credible bidders for its audit tender process.

Conclusion

4.70 In summary, all of the largest audit firms are capable of providing audit services to all of the largest companies. While there are circumstances in which independence issues, sector knowledge and commercial conflicts appear to restrict the choice to fewer than four, these apparent limitations would be overcome were a large company to desire an alternative audit supplier to be appointed or included in a tender. If in some cases one or more of the four large audit firms are relatively weaker or less active in a sector than their competitors, this is a response to the market, not a distortion, and if the market demands "new entry" into a sector by a large audit firm not currently in that sector this can be achieved. In our view, all large companies can invite enough credible audit firms to tender to supply their audits to have an effective tender. As a result, the current auditor is aware that there is a real threat of tendering and switching, and is incentivised to avoid this by providing a high quality, good value and effective audit service.

5 The third pillar: Large companies are effective purchasers

In this section we address the third of our four pillars – showing that large companies are sophisticated and robust audit service purchasers, well able to make effective decisions and evaluate the quality and price of the audit services they are purchasing. In particular we consider:

A The characteristics of purchasers and the purchasing process

B The continuous competitive pressure to provide a good value audit service

C The evidence that large companies are sophisticated and powerful purchasers of audit services (by assessing the capabilities and experience of large company managements and audit committees)

D The price and scope negotiation process that takes place every year between the audit firm and the company - and can be particularly pronounced on the rotation of the lead audit partner; after changes to the board or the audit committee; and after M&A activity

E The tender process - how the ultimate threat of switching is real, notwithstanding that there are significant switching costs for both auditors and their clients associated with moving audit firm

A The characteristics of purchasers and the purchasing process

5.1 The large company purchasers of audit services and the processes they follow in purchasing such services have the following characteristics:

(a) The purchasers are financially powerful and in most cases have sophisticated internal (and/or can bring in external) procurement expertise. The companies operate in competitive markets where, to succeed, they have to minimise their own cost base.

(b) The audit committee, which includes independent individuals with accountancy (and often audit) expertise, plays a prominent role in assessing audit firm performance and agreeing terms of engagement. It draws on the advice of the company's finance director and accountancy and audit experts within the company.

(c) Unlike most other services acquired by the company, there is a regulatory framework governing the process, culminating in shareholder appointment at the AGM. It is in part from this that the audit committee derives its power and influence.

(d) The potential suppliers - the largest audit firms - are well known to the company and may already, or from time to time, provide it with non-audit services.

(e) Members of the audit committee, the finance director and others within the company, will likely have previous (or current) experience of other audit firms which provides a good point of comparison for the existing firm's performance.

(f) The audit contract is for only one year - it has to be renewed annually. This is more than a legal or regulatory formality. It provides the occasion for an annual negotiation on terms and performance and companies take this opportunity.

(g) There are a number of other occasions that may generate a negotiation on fees and performance, in particular the five-yearly rotation of the lead partner which invariably concentrates the thinking of the company on the general effectiveness of the audit firm's performance and whether change should be considered. Other such occasions may also be: when new directors join the audit committee; when the finance director is replaced; and following an acquisition.

(h) If there is dissatisfaction with the current audit firm that cannot be resolved, the contract is put out to tender and in such circumstances more often than not a new audit firm is appointed.

(i) Switching of audit firms results in costs and risks for the company. While these costs and risks do not outweigh the benefits of switching where an audit firm is not providing appropriate quality and value, a company may prefer to avoid them if competitive terms and value can be obtained from the existing audit firm.

5.2 A combination therefore of several factors - the implicit (and often explicit) threat to tender if the existing audit firm does not offer competitive terms and services; the knowledge that if there were a tender because the company was dissatisfied with the service the probability is that the existing audit firm would be replaced; and the desire of companies to avoid the risks and cost of tendering and switching if competitive quality and value can be established by other means - results in tendering being less frequent than in some other markets but nevertheless ensures competitive outcomes.

5.3 In the following paragraphs we describe these characteristics in more detail, but we start by describing how the characteristics manifest themselves in terms of the pressure that companies place on us to provide a good value audit.

B The continuous competitive pressure to provide a good value audit service

5.4 As might be expected, we seek and receive considerable feedback on the price of our audit services and we are pushed hard by companies to justify our prices and value.[226] The examples below show how keenly companies review and contest audit prices – albeit whilst recognising that the fee must reflect the task:

[226] The extent of fee pressure is illustrated by the key risk assessments, which consider a range of risks to the business as a whole and are performed by the Assurance Executive and Executive Board on a regular basis. The competitive pressure and fee pressure is always assessed as a high risk. See also Exhibit 115: [✂]

(a) [✂]: *"We think you're great … but where we're likely to fall out is over the fee."*[227]

(b) [✂]: *"We do watch it pretty closely; what we're paying for."*[228]

(c) [✂]: *"The global fee has substantially improved the relationship so we are not at loggerheads the whole time about value for money".*[229]

(d) [✂]: *"Management were extremely challenging, particularly around fee… overriding concern was that he did not want fees to interfere with the quality of what was delivered and believed that ultimately the balance had been maintained."*[230]

(e) [✂]: *"Aim was to ensure we get paid a full, fair fee to encourage our top people to be motivated to do a great job on [✂] - but not a 'fat fee' which takes advantage of the relationship."*[231]

(f) [✂]: "*Commercial discussion on fees every year. Company doesn't take unreasonable stance and PwC is seen as going out of its way to innovate in relation to approach. Value is therefore not seen as an issue*."[232]

(g) [✂]: "*We're expected by our customers to reduce our costs every year … so then really, really, really we ought to expect that of our suppliers.*"[233]

C Large company management and the audit committee

5.5 In the following paragraphs, we describe the internal processes and pressures faced by management and audit committees in appointing, evaluating and negotiating terms with an audit firm and we review the experience and ability of management and the audit committee to undertake this task.

Internal processes and pressures

5.6 The companies listed on the London Stock Exchange include some of the largest in the world. Some, including 11 of PwC UK's FTSE 350 clients, are also listed on the New York Stock Exchange. In our experience, these companies and their management take their governance responsibilities very seriously. These responsibilities include the resolution to appoint, re-appoint or remove the external auditor (and also to approve remuneration and terms of engagement) which is presented annually to shareholders for their approval in a general meeting by the board, acting on the recommendation of the audit committee.

5.7 It follows that, to be appointed or re-appointed as the auditor for a large listed company, the audit firm must earn or retain the confidence and satisfy the demands and expectations of the members of the audit committee, and also of the board, particularly the finance director. Only then will the resolution be placed before the shareholders.

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227 See Exhibit 6: [✂]
228 See Exhibit 30: [✂]
229 See Exhibit 9: [✂]
230 See Exhibit 116: [✂]
231 See Exhibit 44: [✂]
232 See Exhibit 117: [✂]
233 See Exhibit 7: [✂]

5.8 Prior to recommending the audit firm's appointment at the AGM, the audit committee is required under the UK Corporate Governance Code (2010) (the Code) to undertake a review of auditor effectiveness.[234] In many large companies this is undertaken by surveying the opinions of key finance and wider management who interact with the auditors, the results of which are then tabled at the audit committee and discussed without the auditors present. This exercise is often the vehicle for concerns about the auditor's service quality and/or fees to be aired.

5.9 In considering the appointment of the auditor, the audit committee also receives reports from management and the auditors on non-audit services and fees in order to ensure that they are satisfied both that the non-audit services provided do not raise any independence concerns and that the fees represent value for the services provided. It is required that "*the annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded*."[235] These disclosures are reviewed by institutional and other shareholders as part of the process by which they decide to vote on the auditor's reappointment at the AGM.

5.10 It is not unusual for audit fees in the FTSE 350 to exceed £1 million (and in the case of the largest companies, they are very substantially higher than this). This is a significant sum and can be the largest item in the finance director's direct budget. As the finance director is the individual who sets and enforces cost controls across the business he or she will be under pressure from other senior managers to demonstrate this in his or her own direct costs, thereby inevitably ensuring that there is pressure on audit fees each year.

5.11 The fact that the companies themselves operate in highly competitive markets means they cannot afford either to pay more than the competitive price for their audit or to receive a sub-standard audit which might damage investor confidence or fail to provide the input needed to maximise the business benefit from the audit. A company's failure to ensure that it gets the best from its suppliers - including audit firms - at a competitive price puts the company at a competitive disadvantage in the markets in which it operates.

The relevant experience of management and audit committee members

5.12 The members of the audit committee, together with the finance director, are individually and collectively highly experienced and expert purchasers of audit services:

(a) They are usually individuals who have considerable experience of running large companies, many of whom have a background in accountancy and audit work:

(i) Annex 8 names the members of the audit committee - including the audit committee chair (ACC) (listing any other large company board directorships he or she holds) and the finance director/chief financial officer (CFO) (with a summary of key prior experience) - of our audit clients in the FTSE 350 as at Q3 2011. This table illustrates the calibre and experience of the key individuals at our large company audit clients who are primarily responsible for the decision to select the audit firm for approval by the company's shareholders.

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234 Paragraph C.3.2 of the Code.
235 Paragraph C.3.7 of the Code.

(ii) This information suggests that the FSA's Disclosure and Transparency Rules,[236] requiring at least one member of the audit committee to have competence in accounting and/or auditing, is more than met in the case of our clients.

(iii) Academic research has indicated that on average each audit committee has at least one member holding recognised accounting qualifications, such members often being former auditors.[237]

(b) The information in Annex 8 illustrates that most executive and non-executive board members of FTSE 350 companies have previously held positions in other large companies. Accordingly, there is always the potential for the existing auditor to face challenge from newly appointed members of the board and/or the audit committee of large companies. Such new members bring with them their experience of the audit firm from their previous companies, and from this have an expectation as to the appropriate scope and price of the audit service. To the extent that the company's audit firm is out of line with that experience, the existing audit firm can expect to be challenged.

(c) In addition to previous experience, our internal analysis of senior individuals (senior executives, non-executives and audit committee members) suggests that many of those within the FTSE 350 hold positions at more than one large company concurrently, with around 85-90% of FTSE 350 companies having at least one individual in a senior position[238] who could influence the auditor appointment that simultaneously holds a position within another large company. Many company boards include several such individuals. This directly comparable contemporaneous experience of other companies further helps ensure large companies are able to understand auditor performance and the issues relating to auditor appointments. For example, a [✂] ISPR noted: *"be alert to re-tender risk… there is no appetite currently but [✂] is on several boards where he can benchmark us against other firms…. Fan of a 'fresh pair of eyes'"*.[239]

5.13 The finance teams of large companies closely review all audit scope changes and fee negotiations. Companies' finance teams normally include former auditors who have a very good understanding of what is reasonable in terms of scope and price.

D The negotiation process: When a company assesses its audit firm

5.14 Companies exert competitive pressure on their auditors *outside* the context of a tender process, relying on the threat of tender and switching (whether implicit or explicit) to back up their demands. In addition to the auditor effectiveness review prior to re-appointment, which is discussed in paragraphs 5.8 - 5.9 above, this typically occurs on the following occasions:

(a) in the annual audit scope and fee negotiation;

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236 DTR, paragraph 7.1.1.

237 Beattie, Fearnley, Hines 2011, p44, paragraph 3.3.2. The figure would be higher if focussing on audit committees at FTSE 350 companies. In this research, of the combined set of 498 respondents, 26% were FTSE 100, 39% were FTSE 250, 31% were FTSE small cap and 4% were Fledgling.

238 For instance: CFO, CEO, Chairman, Financial Director, other directors/audit committee members.

239 See Exhibit 5: [✂]

(b) on rotation of the lead audit partner, which can be a particular opportunity for the company to take stock and for competitors to exert pressure;

(c) where key management or directors change at the company; and

(d) where companies merge or are acquired.

5.15 These are discussed in more detail below and we explain the competitive dynamic that constantly exists, in which going to tender is a threat the existing auditor is always striving to avoid by providing the quality, expertise and value for money that large companies expect from their auditors. The largest audit firms closely monitor the position on (b) to (d) across the large company population to focus their targeting efforts.

The annual scope and fee negotiation

5.16 In our experience there is a detailed discussion between the company and its auditor every year on the scope and fees for the next financial year.[240] Where the company is otherwise satisfied with the level of service received, there is always a discussion about the required scope and price for the upcoming year. As [✂] put it in the context of fee negotiations that take place every year: "*There is a good strong arm wrestle that goes on each year.*"[241]

5.17 The discussion around audit scope and fees is typically set out in some detail in the Audit Plan presented by the auditor to the audit committee at the Planning Stage of the audit. An example is attached as Exhibit 119 [✂], in which the "Proposed audit fees" are set out, together with a reconciliation showing how the fees for the current year compare to those for the previous year.[242]

5.18 The annual fee negotiations usually take account of the following factors, depending on the company's situation:

(a) the company's desire for fees to be competitive and give value for money;

(b) increases or decreases in audit scope - for example:

(i) acquisitions and disposals;

(ii) new business activities (new products or services);

(iii) major one-off events (restructuring, refinancing);

(iv) changes in accounting standards or regulation (for example, the transition for UK listed companies from UK GAAP to IFRS in 2006, the implementation of Sarbanes Oxley controls reporting for US Foreign Private Registrants, and the introduction of revised 'Clarity' Auditing Standards in 2010);

(c) changes in the company's systems or processes;

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240 See Exhibit 118 for example: [✂]
241 See Exhibit 26: [✂]
242 See Exhibit 119: [✂]

(d) problems identified in previous audits and changes in the assessed risk of specific financial line items;

(e) inflation, typically having regard to appropriate indices in the countries in which the company operates; and

(f) efficiency improvements that the auditor seeks through improved working practices.

5.19 The above factors can lead to one-off increases or decreases in audit scope and fee from year to year, which can be quite large, or increases or decreases that remain over several years as a change becomes "business as usual" (for example, after a new subsidiary or territory has been acquired or activity commenced in a material new territory). Some areas of change (for example, systems and new standards) can lead to large increments in audit time and fees in the first year or early years, when change is in progress, but have lower effects or indeed fee savings thereafter as the efficiency benefits of the changes occur. In international groups there are typically large numbers of individual changes, including currency fluctuations on overseas subsidiaries' audit fees, resulting in a complex year on year fee reconciliation. As indicated above, these reconciliations are typically summarised in the audit committee papers and discussed at the audit committee meeting which reviews the annual audit plan.

5.20 The level of detail involved in the annual scope and fee negotiation varies between clients. At one end of the spectrum there is detailed discussion of audit hours and fee rates, while other negotiations focus more on the overall reasonableness of movement and total fees. Negotiations typically involve a combination of "bottom up" analysis (where a detailed audit scoping exercise is undertaken across the company's businesses in the UK and overseas, in dialogue with local management) and a "top down" review (which is undertaken by the company's finance team at head office).

5.21 The "efficiency" and price reduction factors identified above are a regular feature of fee negotiations. Large companies frequently require their audit firm to achieve efficiencies in carrying out the audit each year. For example, in our proposal to [✂] we noted that: "*We, like you, also find ourselves in a highly competitive marketplace, and hence have to aim for year on year efficiencies as we cannot easily pass on our cost inflation.*"[243] This means that, in many cases, the audit firm may not be able to pass on salary and other cost increases to clients.

5.22 Although many annual fee negotiations are incremental, basing the upcoming year's fee on its predecessor, increasingly audits are subject to periodic (say three-yearly) "bottom up" reappraisals of time and fees. Such reviews have regard to the overall development of the company's business, individual audit risks and audit tasks, and include fee benchmarking with sector comparators. These reviews can on occasion look forward taking account of the company's expected organisational and systems changes, such as shared services where companies may have major transformation programmes including off-shoring to drive efficiency. Companies which have undertaken such reviews recently include [✂] and [✂] (which has a policy of a thorough review every three years).

[243] See Exhibit 120: [✂]

5.23 At the same time companies also periodically benchmark their audit fees against comparator companies, and apply competitive fee pressure as a result. Using mid-cap companies by way of example:

(a) [✂]: benchmarked themselves and negotiated a fee discount for the last two years (and received an unsolicited offer from one of our competitors);

(b) [✂]: sought the same "headline" fee reduction as a competitor had achieved through a competitive tender process and threatened to put their own audit out to tender to achieve this if we were unable to reduce fee levels (including changes in scope) for 2011; and

(c) [✂]: benchmarked our fee against peers and negotiated a reduction in 2011.

The challenges on rotation of the lead audit partner

5.24 There are particular challenges associated with the fact that lead audit partners are required to rotate every five years in order to ensure that the audit firm is independent – and is seen to be independent – of management. In our experience, even where the company is otherwise satisfied with the level of service we provide, this event often raises the question of whether it might be appropriate for the company to put the audit out to tender. This reflects the inevitable loss of some of the "institutional knowledge" built up by a partner when he or she rotates off an audit. However, a well-implemented partner rotation has the advantage of offering a fresh pair of eyes as well as retaining continuity and institutional knowledge through the rest of the audit team.

5.25 The extracts from our CPRs demonstrate the sensitivity concerning how best to ensure the continuity of the audit appointment at this point. They show that companies require a smooth and sensitive hand-over of lead partner to minimise disruption, and often conduct a non-public "re-tender" on rotation involving only the existing auditor to test new partner capabilities and ensure they are satisfied that the prospective replacement lead partner is suitable. If a company is not satisfied with the new partner put forward, an alternative new partner might be suggested, or the company may decide to hold a full tender with rival firms. The extracts below show the concern clients have about maintaining quality on rotation:

(a) [✂]: *"The client wants to be engaged early on in the process and does not want any surprises. In that context, one NED mentioned that the recent rotation at [✂] where she is also a NED (a 'slightly under cover re-tender process') worked very well"*.[244]

(b) [✂]: This company was concerned about the impact on the relationship with PwC of the lead partner rotating off saying it was "*impossible to have someone who knows [✂] as well as [the current lead partner]*."[245]

(c) [✂]: "*Critical that the partner who replaces [the Partner] had the deep level of technical knowledge which current lead partner had demonstrated*."[246]

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244 See Exhibit 121: [✂]
245 See Exhibit 122: [✂]
246 See Exhibit 123: [✂]

(d) [✂]: "*The audit committee was reluctantly thinking about a tender and given the change of audit partner this provided them with the opportunity*".[247]

5.26 As well as presenting a threat to our position where we are the existing audit firm, rotation is also a source of opportunity. For example, [✂]

Changes to the board or audit committee

5.27 Changes to the board or audit committee (which are relatively frequent) may also provide the impetus for a tender:

(a) [✂]: *"huge opportunity for the audit firm if they get aligned on [the new CFO's] agenda and big risk if they don't"; "he described the challenge for any audit firm to defend their position in the past, while embracing change";* and *"important to stay aligned with the changes new CFO will make and anticipate them if possible."*[248]

(b) [✂]: *"very satisfied with the service…no intention to even consider a change of auditors. A new AC chairman would come on board following the AGM and he may have other views given PwC had been the auditor for many years. While this would not have the support of management at the moment PwC should be aware of this."*[249]

Opportunities and threats on merger or acquisition

5.28 In the event of a merger or acquisition, it is usual for only one audit firm to be appointed to audit the new enlarged group even if immediately after the transaction two audit firms are involved. Companies in the UK have long held the view that joint audits are sub-optimal and inefficient. Examples of companies that have moved away from joint audits include the Shell Group (in 2005) and BHP Billiton (in 2003). Other companies which had used two audit firms have subsequently changed to using a single firm: for example, TUI and Thomas Cook both switched to single audit arrangements.[250]

5.29 The level of M&A activity among the FTSE 350 means that audit firms are under pressure to perform well so as to maximise the chance of being selected in the event of a significant merger. In our experience the auditor of the acquiring company has an advantage and is selected in the majority of cases, but this still leaves the audit firm of the acquired company (or a new firm entirely) with a very real chance of being appointed. Whatever firm is appointed, there is serious consideration given to the choice, and the auditor of the acquirer needs to have provided a high value for money service if it is to be successful. A recent example of the competition created through mergers was [✂]. In recent years we have lost the audits of FTSE 100 companies BAA and Corus, and won Cadbury, through takeovers by overseas companies.[251]

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247 See Exhibit 124: [✂]

248 See Exhibit 125: [✂]

249 See Exhibit 126: [✂]

250 Both TUI (which was audited by KPMG and PwC) and Thomas Cook (which was audited by Deloitte and PwC) switched to single audit arrangements in 2008. TUI and Thomas Cook did not have "joint audits" in the sense of the auditors providing a joint statement, but used two auditors to cover discrete parts of their overall group audit requirement.

251 These companies have since left the FTSE 100.

5.30 M&A activity is a major driver of change in our UK client portfolio and one reason why we continually need to replenish our base of listed clients (see section 4 above). Given that the acquirer's auditor stands a better chance of being appointed for the enlarged group, we target growing or successful companies and overseas corporates which have an objective of expanding or listing in the UK. In this regard, the PwC international network is a particular asset.

E The tender process: How the threat of switching is real, notwithstanding switching costs

5.31 In the following paragraphs we review:

(a) why the threat of switching is credible;

(b) the impact of switching costs for both the company and the audit firm;

(c) why companies tender;

(d) how the tender is approached by the company; and

(e) how the tender is approached by the audit firm.

Why the threat of switching is credible

5.32 We explain below that the costs which both the company and the auditor face in the event of switching create an incentive for both to avoid tenders, *provided* that the company is satisfied with the existing relationship. If the auditor *delivers* an appropriate and high level of quality at a fair price, the company may renew the audit contract without incurring the costs and risks of tendering. However, if the auditor fails to deliver on the required level of quality or price, the company can put the audit contract out to tender, imposing significant costs on the audit firm. As the audit firm has strong incentives to avoid such costs, the threat of tendering acts to constrain prices without the need for companies to tender or switch. The threat of tendering is still very real, for example:

(a) [✂]: The audit was lost having been put out to tender after we were judged to have insufficiently highlighted business control issues [✂]. In particular, "*[t]he issue [✂] had caused a feeling that concerns ought to have been raised more strongly than they were.*"[252]

(b) [✂]: The audit was put out to tender because the company felt that [✂] had "*taken their eye off the ball*".[253] We won the audit due to a track record of providing the company with excellent non-audit services. [✂] said that "*[✂] hadn't taken on board how much [✂] had changed as a business over the years and the fact that their focus was now global, [✂] approach was UK-centric …. [✂] had 'taken for granted' the relationship to date and*

[252] See Exhibit 127: [✂]
[253] See Exhibit 128: [✂]

not invested sufficient time in the relationship."[254] ([✂] was targeted by the Tanks on Lawns initiative described in section 4C above to win new audit work.)

(c) [✂]: The audit was put out to tender by the company following "*a perception that the audit fee was too high amongst Executive Management. [The company] said that [it] "kept pushing" as "[it wasn't] happy with the fee"*[255] and ultimately decided to put the audit out to tender. Although the issue of fees was not a factor in the decision it was "*[a]greed that the audit would not have gone out to tender in 2009/2010 had it not been for the pricing issue of the past.*"[256]

5.33 Even in those situations where the threat of a tender appears to have receded, we cannot afford to be perceived to have taken our "foot off the pedal" in terms of providing the company with a high quality audit service that offers good value for money. This is well illustrated by [✂]: "*the risk of audit tender has died down, but tenure can never be guaranteed in the current climate.*"[257]

The impact of switching costs

5.34 Switching costs may be incurred by both the company and the audit firm.

The switching costs incurred by the company

5.35 There are a number of costs associated with switching which are significant for the company, while not being so high as to prevent the company from moving if it is dissatisfied with the level of service:

(a) the management time and distraction of (i) setting up a tender process; (ii) participating in the process itself (including having meetings with each audit firm); and (iii) introducing a new audit team to the company, is likely to be relatively significant;

(b) direct costs incurred in running a tender process. These will vary depending on the procedure utilised but may be material, particularly if external procurement specialists are involved; and

(c) increased risks for the company in the first few years of the new audit firm, as the new audit team strives to get to know and understand the business to be able to exercise informed judgement on those issues particular to the company and the industry.

Switching costs incurred by the audit firm

5.36 In addition to the switching costs faced by the company, there are also costs faced by the audit firm. These costs are relevant to the incentive the audit firm has to accommodate service and price demands from the company in order to avoid tenders, and include:

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254 See Exhibit 128: [✂]
255 See Exhibit 76: [✂]
256 See Exhibit 60: [✂]
257 See Exhibit 129: [✂]

(a) The significant client-specific investments that audit firms make during a tender process and in the early years of an audit which are effectively "sunk costs". These costs are necessary to ensure that an appropriate quality of audit service can be provided in the first year (and so reduce the likelihood of failure referred to above) and increase the effectiveness and efficiency of performing the audit in future years. In many markets, such sunk costs can be recouped through negotiating long term contracts with the customer. However, because audit contracts are subject to annual shareholder re-appointment, the only way for an auditor to recoup these costs is by offering an ongoing attractive price and service proposition which ensures it maintains the audit appointment from the company for at least a few years to recoup these investments.

(b) Future financial costs (i.e. foregone earnings) as well as reputational costs that the audit firm faces if it loses an audit appointment. In the high-visibility context of the FTSE 350, losing an audit appointment may be damaging to the audit firm's reputation if the reason is dissatisfaction with quality of service or value for money.

Reasons for a tender

5.37 Given the advantages to companies (and auditors) of investing in longer term relationships, actual tenders are less frequent than in some other sectors, although more frequent than the OFT has suggested (see section 4 for further discussion). We have been involved in or are aware of approximately 121 tenders in the FTSE 350 between Q2 2001 and Q3 2011. Of these, 92 resulted in a change of audit firm with the previous auditor winning on 24% of occasions.

5.38 The relative lack of success of the existing auditor in a tender reflects the fact that the most common reason for a large company putting the audit out to tender is because of a relationship breakdown and dissatisfaction with the quality of service from its existing audit firm. The evidence from companies following tenders suggests that companies generally make tender selections on the basis of quality but price is also relevant. For example:

(a) [✂]: *"On the financials [the company]'s attitude was that they needed to get the best firm and could then negotiate. [The company] … had discussions with all of the firms. Before the discussions PwC were 'out of line' but 'that shouldn't be the thing that drives it' 'much more about the best firm' 'needs to be right - best firm'. If it couldn't be resolved only then would it become a show stopper. [The company's chief accounting officer] commented (with a wry smile) that PwC were still more expensive than the others."*[258]

(b) [✂]: *"the fees were more or less the same (in tender process) - PwC spent more time there and made a greater effort than anyone else to understand the business and talk to people."*[259]

(c) [✂]: "*individual is more important than the price but they're happy to market test price where we appear expensive*."[260]

[258] See Exhibit 54: [✂]
[259] See Exhibit 130: [✂]
[260] See Exhibit 131: [✂]

How the tender is approached by large companies

5.39 Where a company decides to tender, the process is usually taken very seriously by the company.[261] The audit committee will normally be involved in setting the terms of reference for the tender and makes the decision on who to select, following presentations from the audit firms. For example:

(a) [✂]: Despite the company opting for a *"short and sharp"* process (as opposed to a *"long drawn out"* one), it still lasted three months (with a six month period allowed for potential auditors to *"cleanse"* themselves of potential independence or conflict concerns), and involved various initial meetings, evaluated presentations to each region/business, and two final sessions with the executive board and audit committee.[262]

(b) [✂]: The process lasted for two months and was very intensive. The four firms invited to participate each met separately with nine members of management, submitted formal proposal documents and then made a formal presentation to 14 members of management. Of the two shortlisted firms, a further proposal document was produced and a formal presentation made to the audit committee plus 12 members of management.[263]

(c) [✂]: The company had a very rigorous process with fourteen people involved in the panel to select auditors.[264]

5.40 Generally, the larger and more complex the company, the longer and more involved the tender process, particularly where the company has significant overseas operations. Internal procurement teams may well be involved in managing the process, and in the case of [✂], the [✂] was employed to run the tender.

5.41 Organising and running such a tender process is time-consuming and costly for the company involved, including senior management. Having incurred the tender costs companies are generally reluctant to undergo a further tender process in the short term.

How the tender is approached by audit firms

5.42 The prospects of winning the audit work for a large company, which through providing quality service and value for money is likely to develop into a long term relationship, incentivises prospective audit firms to compete fiercely to win the appointment. The fact that such tenders occur relatively infrequently (an average of 13 to 14 a year within the FTSE 350 over the last 10 years) requires prospective firms to maximise their prospects of success and incentivises the existing audit firm to respond competitively to client requirements so as to reduce the risk of tenders.

5.43 We go to considerable lengths to attempt to win such appointments:

(a) establishing and building relationships well in advance of a tender;

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261 This is recognised by large companies. For example, Exhibit 132: [✂], where the CFO *"acknowledges the huge cost that all firms put in and accepts that to compete all firms have to put in that level of effort"*.

262 See Exhibit 54: [✂]

263 See Exhibit 133: [✂]

264 See Exhibit 134: [✂]

(b) sharing our thought leadership and insight on topics relevant to target companies;

(c) undertaking company and sector research to ensure the business issues are understood and responded to;

(d) attending scoping meetings at a variety of locations, often involving overseas travel, and levels in the company;

(e) preparing high quality proposals and presentation materials;

(f) involving non-auditors to demonstrate specialist expertise which will be critical to performance of the audit;

(g) partners and staff not working on the tender challenging the proposal team's approach; and

(h) flying in key members of the team from overseas locations for key meetings and presentations.

5.44 Our proposal costs can be significant. For example, our analysis shows that, based on a small sample of seven proposals drawn from the period 2009-2011, proposal costs ranged from [✂]. Notwithstanding the broad range in proposal costs between tenders, it is apparent that they represent a substantial investment in winning a new appointment.[265]

Conclusion

5.45 It follows that relatively low switching rates in this market are not indicative of any dampening of competition. Given that the rate of switching in a market depends in each case upon the costs and benefits of switching, the evidence above demonstrates that where the company is otherwise satisfied with the level of service received from, and price paid to, the existing audit firm – things it is well-placed to benchmark on an ongoing basis – there are no benefits to be gained from switching, and so switching rates will naturally be low. The audit firm is strongly incentivised to ensure that the company is satisfied with the level of service and value for money, in the knowledge that tenders are not uncommon when there is dissatisfaction and, when they occur for this reason, the existing audit firm more often than not fails to be re-appointed.

[265] [✂]

6 The fourth pillar: The market operates efficiently

In this section we address market outcomes. In particular we show that:

A Audit services sold to large companies are priced at competitive levels

B The profitability of these services is not excessive. Furthermore, profitability is not affected by factors such as:

- **our length of tenure as auditor;**
- **the extent of non-audit services we provide to the audited company (within the existing independence rules); or**
- **the degree of sector concentration.**

C There is evidence of innovation and quality in audit service provision

D Possible regulatory changes will have unintended consequences for the competitive process

6.1 In the sections above, we have discussed the value of an audit; how large companies need certain attributes from their auditors; how the large audit networks which have these attributes compete fiercely with each other; and how the large and sophisticated purchasers who form the referred market understand the audit service and are able to exert competitive pressure on their auditors with or without the need to tender their audits formally.

6.2 In this section we consider the competitive outcomes in the large company audit sector, and demonstrate that these are consistent with what would be expected in a well-functioning and competitive market.

A Audit pricing

6.3 In a market where competition was not functioning effectively, one would typically expect there to be some indication of this in the way in which suppliers priced their services. If, as has been suggested, the large audit firms had market power, it would be expected that they could price their services at a higher level than would be the case in a competitive market and largely independent of competitive pressure. However, this is not reflected in audit pricing in practice.

6.4 [✂]

Figure 10: [✂]

6.5 [✂][266]

6.6 The decline in realised hourly rate covers both situations where we have responded to pressure from the company to reduce fees for a broadly consistent scope of work (i.e. hours of input) and also those where to meet the company's (or our own) needs, we have increased scope/hours without a corresponding increase in fee, particularly so as to focus on quality and respond to the implications of the difficult economic environment.

6.7 [✂][267]

6.8 [✂][268]

6.9 As this evidence makes clear, our experience shows that clients put considerable pressure on audit prices to which we need to respond, and we have faced considerable difficulty in even achieving price increases necessary to keep pace with inflation. Clients have used changes in the audit scope (such as on mergers) and tenders to negotiate reductions, but the threat to tender is the most commonly used tool to negotiate fee reductions. One way we have responded to such pressure on fees is by improving our efficiency and reducing our costs, passing on the benefits of the efficiency savings to our customers in reduced fees.

B Audit profitability

6.10 In a market characterised by market power (or tacit collusion), one may expect to find high levels of profitability. In contrast, in competitive markets, firms find it difficult to earn profits that are consistently in excess of a "normal" return (i.e. cost plus a required return), since profits in excess of this normal level are competed away.

6.11 Our audit profits are at a level consistent with intense competition, and cannot be considered excessive by reference to relevant benchmarks.

6.12 We are mindful of the complexities of providing a meaningful profitability figure in the context of a multi-disciplinary partnership. Obvious issues are:

(a) exactly which services should be considered as audit services relevant to the profitability calculation;

(b) precisely which costs can be attributed to the provision of those services;

(c) how to quantify the intangible assets - i.e. a skilled and trained workforce, intellectual property in methodologies and thought leadership, and "trust" put in the firm (through its brand value) by clients; and

(d) in relation to equity partners in the business, how much of their overall share of the partnership profits can be considered as true profitability, given that partners are not paid

[266] See Exhibit 115: [✂]
[267] See Exhibit 115: [✂]
[268] See Exhibit 115: [✂]

a separate salary (and so a partner "salary cost" must be considered before a realistic profitability figure can be determined).

6.13 For the purposes of this initial profitability analysis, we have:

(a) considered the profitability of our *"statutory audit and directly related services"* as defined in our Transparency Report.[269] We note that trying to look at the profitability of statutory audit in isolation would be both difficult and meaningless given that directly related services are often priced with the statutory audit service, and always provided by the auditor; and

(b) used operating profit margin (i.e. earnings before interest and tax (EBIT) divided by revenues) as our starting point. This is the agreed measure used by auditors when disclosing audit service profitability in their Transparency Reports in line with an industry code established under the auspices of the FRC.[270]

6.14 There are several advantages to using operating profit margin as a measure of profitability for audit services, including:

(a) Operating margin is the measure used by firms in their Transparency Reports. Within PwC, gross (rather than operating) profit margins are an important measure used for budgeting purposes. However, gross profit margins do not include an allocation of firm wide costs, and are thus not appropriate for the purposes of benchmarking our profits with other companies and in a competition context. Operating profit margins are related to the gross margin which we use within the business, but are a better measure for making comparisons and taking into account costs.

(b) Profit margins do not require an assessment of our capital / equity base. In common with most other professional services firms, our internally-generated intangible assets, such as intellectual property, are of critical importance and any analysis which ignored the value of these intangible assets would be fundamentally flawed. However, calculating their value in an objective way that meets the needs of a competition inquiry would be extremely challenging.

(c) We note that the CC acknowledged this concern in its review of classified directory advertising services[271] referring to its own 2003 guidelines, which state:

> "*The Commission recognises the difficulty in measuring the cost of capital and its limited applicability to some industries, <u>such as some markets for services and products with a high intellectual property value</u>. In such situations the Commission*

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269 See Exhibit 17: PwC's FY11 Transparency Report (*Doing the right thing: delivering quality audits, 30 September 2011*). The formal statutory obligations to produce a transparency report are found in the Statutory Auditors (Transparency) Instrument 2008 (POB 01/2008) in Exhibit 135.

270 This was suggested by the Market Participants Group (MPG) set up by the Financial Reporting Council (FRC). As part of implementing the MPG's recommendations, the FRC invited the Consultative Committee of Accountancy Bodies (CCAB) to develop a voluntary industry code of practice on how auditors should report audit margins on a comparable basis. These guidelines were produced in consultation with PwC, KPMG, Deloitte, E&Y, BDO, Grant Thornton, PKF and Baker Tilly. They state that "*the reporting firm should disclose turnover and operating profit for the reportable segment, with a description of the basis on which these numbers are derived*" - see Exhibit 136: CCAB, "*Voluntary code of practice on disclosure of audit profitability*" (2009), paragraph 17.

271 See: Competition Commission, Classified Directory Advertising Services (2006).

may consider alternative measures, such as the return on sales or other relevant financial ratios."[272] [emphasis added]

6.15 In order to consider whether our level of audit profitability is reasonable or "normal", we have benchmarked our audit margins in (FY11) against the average profitability of the firms in the FTSE All-Share index.

6.16 We consider this benchmark to be reasonable because:

(a) Firms in the economy as a whole can reasonably be assumed to operate in generally competitive markets. The FTSE All-Share index contains approximately 98% of the UK's market capitalisation[273], and so represents a wide section of UK public limited companies (PLCs). It is therefore highly likely that, on average, these UK PLCs face competitive pressures, and on average tend towards earning "normal" profits.

(b) Financial information on PLCs is publicly available and is prepared according to standard accounting principles (e.g. International Financial Reporting Standards). The ability to obtain such information for a relatively large sample of comparators (see below for more detail) also makes outliers and unusual features of individual firms less likely to skew the overall results.

6.17 Based on our initial analysis, we found that the average operating profit margin in FY11 (as at 30 June 2011), weighted by market capitalisation, for all firms in the FTSE All-Share[274] (excluding nine companies that have insufficient data for FY11[275]) is 23%.

6.18 We compared this figure with the operating profit margin for our audit services as reported in our FY11 Transparency Report:

(a) Our audit operating profit margin is 14%. Even based on a simplistic comparison, our audit services in FY11 have a lower profitability than the weighted average of FTSE All-Share companies (23%).

(b) Our overall UK firm operating profit margin was 28% in FY11. This is broadly in line with the average figure for firms in the FTSE 350.

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272 See: Competition Commission, *"CC3 Market Investigation References: Competition Commission Guidelines"* (2003), paragraph 3.85.

273 See Exhibit 137: FTSE: "Factsheet: FTSE All-Share Index" http://www.ftse.com/Indices/UK_Indices/Downloads/FTSE_All-Share_Index_Factsheet.pdf. (Last accessed 5 Dec 2011.)

274 Data from Capital IQ: latest financial information as at 30 June 2011; FTSE All-Share constituent list as at 2 December 2011. Capital IQ does not provide a historic constituent list, however changes between June 2011 and December 2011 are minimal. Primary listings only i.e. includes only companies that have chosen the London Stock Exchange as their main exchange on which to be listed (normally this is the stock exchange where the company has the largest market capitalisation, if it is listed on multiple stock exchanges) – 604 companies in total.

275 A number of constituents of the FTSE All-Share were excluded due to a lack of publicly available data on their EBIT and/or revenues. These are: BH Global Limited; BH Macro Limited; BlackRock Frontiers Investment Trust PLC; John Laing Infrastructure Fund Ltd; International Power Plc; Anglesey Mining PLC; and Cairn Energy PLC. Global Floating Rate Income Fund Limited and Spirit Pub Company PLC were excluded as they are relatively recent listings on the FTSE All-Share and as a result did not have a full year of financial data. This leaves 595 companies in the analysis. Operating margins for Reed Elsevier PLC, Ophir Energy Plc and Impax Asian Environmental Markets Plc are calculated using 2010 financial data, which for these companies was the latest available.

(c) However, we do not believe such simplistic comparisons are like-for-like, since PwC is structured as a limited liability partnership (LLP) rather than a PLC.[276] Any consideration of "partner salary" in relation to our UK partners would significantly *reduce* our profitability in comparison to these benchmarks.

6.19 The level of profits generated in our audit business therefore appears to be lower than those of businesses which can reasonably be regarded as operating in competitive markets. This is consistent with our experience of a competitive business environment in which we are forced by pressures from our clients and competitors to keep our prices for audits, and hence our profits, at the lowest levels that make commercial sense. Moreover, the evidence is completely inconsistent with a market where the main suppliers have market power.

6.20 The fact that profitability is not excessive can also be demonstrated if partner rewards at the top accountancy firms are compared with those of other professional services firms. This is relevant because ultimately, potential employees may make the comparison when choosing their career paths. One example is leading law firms, where a high-level comparison shows that the average profit per equity partner is in many cases higher than that at PwC.[277]

6.21 As might be expected, partner rewards are higher at PwC than at the mid-tier firms, reflecting the need for us to attract and retain the most talented people to undertake the complex and difficult work associated with providing professional services to the largest global companies. Executive remuneration differentials between companies occupying different market positions are common across industry sectors, but are particularly relevant to firms which trade primarily on the intellectual and other skills of their people.

6.22 Our achieved profitability is not depressed by inefficiencies, whether in the form of "gold-plating", unnecessary procedures or pure "X-inefficiency" (the economic term for a situation where costs for a given level of output are above the minimum achievable). Because we are a partnership where the owners are the key executives, intimately involved in leading day-to-day operations, there is every incentive for such inefficiencies to be eliminated, as they directly affect partner remuneration.

6.23 Having explained why overall levels of profitability are not excessive, we deal below with the specific situations that show that profitability remains at reasonable levels when assessed against (a) length of tenure; (b) non-audit services; and (c) in more "concentrated" sectors.

Profitability against tenure

6.24 The Issues Statement suggests that what the CC regards as infrequent tendering is characteristic of limited rivalry, implying that more frequent tendering and switching would increase rivalry and hence, among other things, reduce prices. If this were the case, one might

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276 In a partnership, each partner can be thought of as a combination of: (i) an executive employee, for time spent running the business; and (ii) a shareholder, since they own a stake in the business. However, distributed profits reward partners for both roles without distinguishing between them, and no partner costs are captured in the accounting profit and loss statement. In contrast, PLCs pay their executives a "salary" that is reflected in their operating costs. This salary typically includes: base pay, cash bonus, pensions and long-term incentives (LTI) such as stock options.

277 See http://www.thelawyer.com/pictures/web/q/f/t/pep_p97.jpg. There are seven law firms listed as having profits per equity partner in excess of £1 million for 2011, which is substantially higher than the average figure of £763,000 for our partners (as per our 2011 Annual Report).

expect that companies that did switch auditor would achieve lower prices (and hence generate lower profits for the audit firm) than those who used the same auditor for some time.

6.25 Our analysis shows that the level of profitability we achieve on individual audits is not correlated with the length of time over which we have been auditor (tenure). As was explained and evidenced in section 5 above, this is because companies are able to exert pricing pressure on their audit providers throughout the duration of audit relationships. The chart below shows profitability (in terms of the CPy – client profitability – measure used internally at PwC) against audit tenure. As can be seen, there is no correlation between profitability and length of tenure.[278]

Figure 11: [✂]

Profitability and the sale of non-audit services

6.26 The Issues Statement suggests that we (and other large audit firms) might use our position as auditor to give us an advantage in winning non-audit work with the same customer. This might imply that we would price low on audit services in order to secure (more profitable) non-audit work from the same clients.

6.27 In section 4 we showed that, on average, we earn substantially less non-audit revenues overall from FTSE 350 companies which are audit clients than we do from FTSE 350 clients which are not audit clients. It is clearly not necessary for us to be the auditor in order to win substantial non-audit revenues. This is to be expected. PwC is a leading supplier of a number of non-audit services, able to sell such services to the largest companies, whether or not they are an audit client. We do not need to secure the audit to be a credible supplier of non-audit services to such companies.

6.28 What does change when we are the auditor is that we must abide by regulations and audited company policies that restrict the non-audit services that we can supply. These restrictions are aimed at ensuring public confidence in the independence of the external auditor, and we understand and adhere to them.

6.29 Given that independence restrictions limit the non-audit services that we can supply to our audit clients, and that we have highly competitive non-audit service propositions, there would be no logic in our seeking to reduce the audit price in order to gain audit contracts and win non-audit work for the same clients. Our overall non-audit work potential is diminished where the audit is won.

6.30 This reality is demonstrated in the chart below, where we relate individual audit client achieved profitability (as measured by CPy for audit services) to the proportion of non-audit work which we carry out for that audit client (expressed as the ratio of non-audit fees to audit fees), with each dot representing a PwC FTSE 350 client.

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278 [✂]

6.31 As can be seen, there is no correlation between our achieved profitability on a given audit and the relative extent to which we supply non-audit services to that client. In particular, there is not the inverse relationship which would be expected if it were true that, at the individual client level, we accepted lower audit profits in return for securing higher non-audit fees.

Figure 12: [✂]

Profitability in more "concentrated" sectors

6.32 The Issues Statement suggests that the level of concentration in particular sectors might be expected to increase the degree of market power of the audit firms that are present in such markets. This reflects a similar point in the OFT Decision.[279] "Concentration" in this case means a small number of auditors (i.e. fewer than four) currently supplying the customers in a particular industry sector (even though there may be relatively few of these within the FTSE 350). If this "concentration" did increase market power, then this would be expected to result in prices, and by extension profits, that were higher in concentrated sectors than in less concentrated sectors.

6.33 In fact there is no evidence of a relationship between our achieved price/profitability and whether an audit client operates in one of the sectors which the OFT has identified as relatively more concentrated. We show this graphically in the following diagram which shows our profitability for each of our FTSE 350 audit clients in FY2011 in relation to those sectors which the OFT considers to be particularly concentrated (banking, mining, utilities and manufacturing). Note this chart measures our profitability again using the CPy measure. As can be seen, there is no observable relationship between client profitability and market concentration.

Figure 13: [✂]

6.34 That there is no correlation between the degree of "concentration" – as defined by the OFT – in individual industry sectors on the one hand, and our achieved prices and profitability in the different sectors on the other, is illustrative of the wider point that it would be wrong to make assumptions about the degree of competition in the audit market generally based on simplistic observations regarding "concentration".

6.35 The Issues Statement asserts, in paragraph 25, that the reference market is highly-concentrated. This assertion is based on OFT figures for the Hirschman-Herfindahl Index (HHI) for the FTSE 100 and FTSE 250, calculated using market shares of audit fees. In fact a more

[279] The OFT's position is largely based on analysis flowing from the Oxera report of April 2006. Our critique of the Oxera econometric analysis (which purported to show a relationship between market share and concentration on the one hand and prices or profits on the other) is now in the public domain at http://www.pwc.co.uk/eng/publications/competition-and-choice-in-the-uk-audit-market.html#ns_source=site_search. We do not therefore intend to revisit the topic here, other than to note (as discussed with the CC previously) that it is now clear to us that both the Oxera report and the PwC critique were based on a dataset (Fame) which we now know to be unreliable.

careful analysis of the appropriate calculation of the HHI for audit services to the FTSE 350 shows that this market is only moderately-concentrated.[280]

6.36 A degree of concentration that would be regarded as only moderate if it were observed in a mass consumer market consisting of many millions of individual consumers is even less problematic when observed in a market defined in such a way as to consist of only a few hundred of the largest and most sophisticated companies in the UK. There is a natural arithmetical tendency for the measured HHI to rise as the number of buyers is reduced – fewer buyers provide fewer opportunities for fewer suppliers. Furthermore, where the reduction in buyer numbers is a result of defining the market so as to consist only of the largest buyers, economies of scope and scale mean that there are also commercial and efficiency reasons why one would expect the number of suppliers to be fewer.

6.37 In any case, there are many examples of markets where four main suppliers are considered perfectly adequate to ensure effective competition – indeed, there are many examples of mergers cleared by the EU and UK competition authorities which have resulted in a reduction in the number of main suppliers from five to four.[281] The adequacy of four main suppliers is even more evident in business-to-business markets involving large and sophisticated company buyers who are able to manage their supply base effectively. We set out the evidence in section 5 above demonstrating how this is indeed the case in the large company audit market.

6.38 Furthermore there are no benefits resulting from the entry of more suppliers when there is already effective competition and there are economies of scale and scope.[282]

6.39 It is important that the CC should recognise from the outset that the presumption that the large firm audit market is highly concentrated - based on either the simple observation that there are "only" four large audit companies, or the mechanistic application of standard HHI calculations - is misleading, and could be unhelpful as the backdrop to a proper analysis of competition. Of more importance for the CC's work than taking any particular view on the extent of concentration is a thorough analysis of how competition actually works in the large company audit market.

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280 Based on numbers of audits, because this is a more valid measure of market shares than fees in this market, and comparing with HHI thresholds based on far more up-to-date guidance than that of the OFT – see Annex 9.

281 This policy position is recognised, for example, in Para 5.3.5 in the OFT/CC joint Merger Assessment Guidelines, Sept 2010: "*In relation to the number of firms, previous OFT decisions in mergers involving retailers suggest that the OFT has not usually been concerned about mergers that reduce the number of firms in the market from five to four (or above).*" The fact that issues would be unlikely to arise in the context of such business-to-consumer markets (where four suppliers would be dealing with millions of relatively un-empowered consumers) only makes more explicit that issues should not be *assumed* to exist in a market where four main suppliers deal with a relatively small number of highly sophisticated and powerful purchasers.

282 To supply high quality audit services to large companies requires large investments in methodologies, technology, people and an international network. If these required investment costs were incurred by more than four main firms then economies of scale would be lost and unit costs and prices would need to be higher. Where sophisticated buyers are able to achieve a competitive outcome by playing off the existing suppliers one against the other, the available prices and profits provide no incentive for another supplier to make the required investment, and it would be inefficient and raise prices if one did. There is a wealth of economic literature, sometimes referred to as the "new industrial organisation" that suggests that where there are economies of scale and buyers require high quality services, the more competitive the market the higher can be the natural level of concentration.

C Quality and innovation

6.40 In competitive markets there should be evidence of high quality and innovation as firms strive to outperform each other and gain a competitive advantage. We have discussed the importance of quality in section 2 above, and the characteristics required of a large audit firm in section 3.

6.41 In section 4 we discussed how the large audit firms compete through innovation and investment, and highlighted in particular the efforts that we and the global PwC network of firms make in ensuring our audits are as efficient and effective as possible, and how we strive to continuously improve client service. Examples of such innovation particularly through the Audit Transformation Programme (and discussed in detail in section 4) are:

(a) the global audit methodology tool, Aura;

(b) the Global Assurance Delivery Programme (GADM);

(c) initiatives such as the PwC Experience and Value without Compromise (VwC); and

(d) changes to staff working hours and methods to improve productivity.[283]

6.42 Notwithstanding the obvious and tangible evidence of innovations we are making to improve quality, we continually review the level and appropriateness of the quality of our audit services. This is not straightforward, as no single assessment is likely to capture all the various facets of audit quality. In its 2006 discussion paper on "Promoting Audit Quality", the Financial Reporting Council commented that "*There is no single agreed definition of audit quality that can be used as a 'standard' against which actual performance can be assessed*."

6.43 In addition, it is not transparent what level of quality against the different facets would be appropriate. For example, to deliver a near risk-free audit opinion would require a massive effort and cost which are not required by the regulations and would not be seen as cost effective by the different stakeholders of the external audit. We need to take a view of the level of quality required, on the basis of regulatory obligations and customer demands, and monitor our performance against that.

6.44 We do this through a number of mechanisms, many of which we have described in earlier sections. In particular we listen to what important stakeholders – regulators, investors and companies – tell us about what is needed and how we are performing in meeting that need. We monitor (as far as is permissible) what our competitors are doing. We learn any lessons from other analogous services (e.g. the business services supplied by other parts of PwC). We then decide what is an appropriate level of quality and adopt this as the "PwC Audit requirements".

6.45 Based on the available intelligence, and notwithstanding the inevitable subjectivity of any judgement in this area, we believe that we deliver an appropriate level of audit quality that is neither too low (as it might be in the absence of sufficient competition and regulatory standards); nor is it too high (as it might be if, as the Issues Statement suggests, we were "gold-plating" our services).

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[283] See also Annex 6 in relation to the Audit Transformation Programme.

Quality outputs

6.46 Quality outputs depend upon quality inputs. We describe in paragraphs 2.37 - 2.42 above how we ensure that we have high quality inputs with reference to the drivers of audit quality described by the FRC in its Audit Quality Framework.

6.47 We recognise the importance of audit quality inputs but our goal is also to obtain evidence that quality and innovation outcomes are at an appropriate level consistent with the demands of companies and our regulatory obligations.

6.48 In the remainder of this section we describe the more recent findings of various available measures of audit quality outputs/outcomes. In particular we focus on:

(a) the findings of external assessments;

(b) internal quality review assessments including Engagement Compliance Reviews (ECR) and the Quality Key Performance Indicator (KPI) process;

(c) feedback from informed and sophisticated customers, including market research; and

(d) the reduced level of litigation activity affecting the firm.

External assessments

6.49 As explained in section 2, we (in common with all other firms that audit companies with certain characteristics) are inspected by the AIU, and we are also subject to review by the FRRP. In respect of clients that are registered with the US Securities and Exchange Commission, we are inspected by the US Public Company Accounting Oversight Board (PCAOB) in cooperation with the AIU. These bodies assess technical quality in terms of compliance with the various regulatory standards.

The Audit Inspection Unit

6.50 As noted in section 3, our performance in AIU assessments (where in 2011 only 7% of audits reviewed were judged to be in need of improvement) should be considered in the context of the size and complexity of the audits that we undertake compared to smaller audit firms.

The Financial Reporting Review Panel

6.51 FRRP press releases since 2005 also reinforce the sense that the risk of “defective” audits is higher with smaller firms (as discussed in section 3 above).

The US Public Company Accounting Oversight Board

6.52 As mentioned above, we are also inspected by the PCAOB with a view to measuring our audit quality. The PCAOB commenced an inspection in May 2011 and is not expected to announce its findings publicly until 2012 at the earliest (as noted in the PwC 2011 Transparency Report[284]). The previous PCAOB inspection report was published in September 2008 and

[284] At page 51.

reported that the inspection team did not identify (a) any performance issues that resulted in the firm failing to obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements and (b) anything that it considered to be a quality control defect that warrants discussion in a board inspection report.

Internal assessments

Engagement Compliance Reviews

6.53 As explained in paragraph 6.48 above, Engagement Compliance Reviews (ECRs) are one of the mechanisms that we use to monitor audit quality internally. These are cold reviews of completed audit engagements. Each engagement review is classified as either "compliant", "compliant with review issues" or "non-compliant". A "non-compliant" classification means that relevant Generally Accepted Auditing Standards (GAAS) and PwC Audit requirements and/or relevant GAAP requirements and/or documentation requirements were not complied with in respect of a material matter.

6.54 The table below shows the number of audit engagements reviewed in each of 2009, 2010 and 2011 and the percentage classified as compliant/compliant with review issues or non-compliant. No FTSE 350 clients were identified as non-compliant in any of the years 2009 to 2011 inclusive.

Figure 14: Outcome of ECR assessment

PwC	***2009***	***2010***	***2011***
Number reviewed	[✂]	149	163
Compliant/ Compliant with review issues	[✂]	96%	94.4%
Non-compliant	[✂]	4%	5.6%

6.55 Overall, the level of "compliant"/"compliant with review issues" findings has remained high and relatively constant over time. While we would like to achieve 100% compliance, this level of performance shows that audit quality is delivered to a high and compliant standard, and that this has consistently been the case over time.

Quality Key Performance Indicators

6.56 We also consider Quality KPIs. In the year to 30 June 2011, 13 audit quality KPIs were assessed covering various aspects of the audit from planning to completion. The KPIs are assessed quarterly through the "hot" review of files by partners and staff who are independent of the engagements under review. Poor performance on the KPIs can impact on employee and partner appraisal and remuneration. We have changed the KPIs for the year ending 30 June 2012 to reflect points arising from the AIU report and the 2011 ECR to drive further improvements in quality.

6.57 The table below shows the overall audit quality KPI score for the year ended 30 June against the target score for that year. We have provided this for 2010 and 2011.

Figure 15: Outcome of KPI assessment

PwC	***2010***	***2011***
Overall quality KPI score	94.8%	94.9%
Overall quality KPI target	95%	95%

6.58 The KPI process is managed centrally but is operated by the business units. The KPI reviews cover all clients and do not separate FTSE 350 parent clients or their individual subsidiary audits from other types of audit. As the KPI reviews are an ongoing process and address phases of the audit they are a driver of quality and not an absolute measure. For example, an audit may have an item identified at the planning stage of an audit but which is resolved by the final reporting or signing phase. It is apparent that we are very close to the target levels, and we are consistently delivering a high quality outcome. However, we are not complacent about the quality of our work and recognise that continuous improvement and monitoring is needed[285] - our KPIs are set at levels which require us to strive to achieve the target, and not at levels which can comfortably be exceeded. They are also changed frequently, removing KPIs from areas where we are apparently performing well and inserting new KPIs to address areas which our ECRs suggest we need to improve.

Feedback from customers

6.59 As explained in paragraph 2.67, we collect a wide range of feedback from customers and prospective customers in the form of ISPRs, CPRs, CSS, PDRs and the audit relationship risk diagnostic. One aspect that is covered by this feedback is the quality which we deliver.

6.60 Much of the feedback cited earlier in this submission alludes to customers' views of quality, because the quality demands of customers, and how we match up to them, are important drivers of our competitive success. Further examples include:

(a) [✂]: *"I am very happy to recommend PwC to anybody. The quality of the teams in my experience is higher than [✂]"*.[286]

(b) [✂]: *"The client is 'very pleased with the way that all of our work is delivered. It is seen as high quality, clearly communicated and on a timely basis.'… In comparison to other accountancy firms, the client 'noted he sees us as the strongest technically and quality wise.'"*[287]

285 One advantage of Aura is that it facilitates central monitoring of the extent to which PwC audit policies have been applied.

286 See Exhibit 138: [✂]

287 See Exhibit 139: [✂]

(c) [✂]: *"PwC is 'ahead of the pack' predominantly reflecting a higher quality of people across the organisation."*[288]

6.61 We commissioned a YouGov survey in 2011 to explore attitudes to audit quality and potential reforms by regulators.[289] The target survey group was CFOs and audit committee chairs of 120 large businesses in Europe. Of those surveyed, the vast majority (92%) said that they were pleased with the quality of their external audit.

6.62 A further indication of customer views of the level of audit quality is the relative scarcity of tenders. Given that the main reason that customers choose to switch is when they are dissatisfied with the service that they are receiving, and that this dissatisfaction often stems from sub-optimal quality, the fact that customers switch relatively infrequently suggests a general level of satisfaction with audit quality.

Litigation activity

6.63 The higher the audit quality, the lower the likelihood of an audit firm facing related litigation activity.

6.64 Our claims record arising from statutory audit work has improved considerably over the last 12 years to its current low level, and at this time we have no claims issued by audit clients in the UK. The cost to the UK firm of handling issues and claims, including resolving them, has diminished significantly over this period.

6.65 The reasons for this significant improvement are:

(a) a sustained emphasis on quality in the provision of the audit;

(b) enhanced risk management processes, including those for client acceptance, engagement quality and resolving issues as they arise on individual audits; and

(c) a reasonably stable economic environment until 2008 (although of course current conditions suggest stability may not return in the short term).

6.66 While issues with audits will occasionally arise, those issues have reduced in significance and the incidence of audit client collapse has reduced. If a company fails, the audit may well be called into question as the audit firm may be viewed as *"the last man standing"*, even though the cause of the collapse is not audit related.

6.67 Notwithstanding that our litigation experience in the UK has improved significantly in recent years, the litigation risks of operating in the audit sector are still very significant. We are very conscious of the unlimited liability risk we take on as auditors, and this may be a deterrent to smaller firms' expansion strategies (although this liability "cost" has to be factored alongside the more significant investment costs described elsewhere which are required to try and build the attributes needed to be competitive). To the extent that liability risk is a barrier to entry for smaller firms, this should be addressed by meaningful liability reform.

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288 See Exhibit 140: [✂]

289 See YouGovStone European Audit Committee Chair and CFO Poll (June 2011) (B11(1)).

D Possible regulatory changes will have unintended consequences for the competitive process

6.68 The market for large company audit services is characterised by competitive pricing, normal levels of profitability, high quality and constant innovation. These are outcomes that one would expect from a competitive process operating within a regulatory framework. As the CC is aware, there are a number of proposals for changes to regulation being considered. While this submission is not the place for a detailed discussion of these proposals, the prospect of regulatory change - independent of any findings by the CC arising out of this inquiry - has to be taken into account in assessing competition, and we do so in various places in this submission.

6.69 For convenience we set out in the following paragraphs a short summary of our concerns about the impact and possible unintended consequences of some of the proposed regulatory changes on the competitive landscape, recognising that these are matters that we and the CC may wish to address in more detail as the inquiry progresses:

(a) More frequent tendering would drive up costs for both audit firms and companies engaging in the tender process, and in all likelihood would mean that tenders would become more superficial (meaning a greater likelihood of poor or inefficient decisions being taken) or became token processes run to meet regulatory requirements rather than to actively test the market. Requirements for more frequent tendering at fixed intervals would drive inefficiency by taking the timing of such decisions out of the hands of the companies who are best informed about when such a process is to the company's advantage.

(b) Requirements for more frequent switching may reduce choice as the existing auditor would be ineligible, while smaller audit firms which do not have the necessary attributes absent this regulatory intervention would not become realistic alternatives because of it. More frequent switching would also sacrifice (at arbitrary points in an audit relationship) the institutional knowledge and the incentive for both the audit firm and company to invest in the audit firm acquiring that knowledge, both of which are critical to the provision of a quality and cost-effective audit.

(c) A requirement for joint audit appointments would damage the ability of the audit provider to take responsibility for the group audit statement, and would increase the likelihood of things "falling between" the two (or more) appointed audit firms. The need to appoint two audit firms and the complexities of liaising between the two firms would almost certainly increase costs. The almost complete absence of joint audits from the current UK market - despite there being nothing to prevent companies appointing joint auditors - reflects their unattractiveness to companies. The notion that smaller firms might gain experience through joint audits that would make them better able to carry out large company audits is flawed in that it is the investment in capabilities that is critical to being able to do this.[290]

(d) A requirement to separate audit and non-audit services either in terms of the offering to particular clients, or by requiring entirely separate firms, would: (i) reduce the attraction of audit work to firms; (ii) fundamentally damage audit quality to the extent it limited the

[290] See paragraph 3.58 above in relation to the role played by Mazars.

auditor's ability to involve non-audit expertise; (iii) consequently drive up audit costs and/or reduce audit quality and choice; and (iv) restrict customer choice where those customers are sophisticated buyers and are cognisant of the importance of maintaining auditor independence in their own corporate governance procedures.

6.70 As the above parts show, the current regulatory framework - in which there are independence restrictions to ensure non-audit appointments do not compromise auditor independence and where companies are otherwise free to decide:

- whether and when to tender their audit;
- whether and when to switch auditors;
- whether and when to instruct joint auditors; and
- the extent to which they would like a single firm to provide both audit and non-audit services

- would appear best-suited to stimulating competition between firms and encouraging continued innovation and investment to improve audit quality and efficiency.

7 Detailed response to the theories of harm set out in the Issues Statement

7.1 We have set out our observations on the Issues Statement in sections 1A to 1C of the Executive Summary. In these sections we explain why the market characteristics described in paragraph 9[291] do not give a full picture of how the market operates and why paragraph 10 gives rise to both substantive and procedural concerns. Our observations on the possible adverse outcomes section of the Issues Statement[292] are covered in section 6 of this submission. We do not propose to repeat these comments again.

7.2 In this section we expand on why the six theories of harm identified by the CC in the Issues Statement[293] cannot be substantiated. In doing so we draw on the evidence set out in the preceding sections.

(a) The audit market is highly concentrated and there are high barriers to entry with the result that the four largest firms have market power

There is no market power

7.3 This theory of harm is based on the misconception that, in a market with at least four well resourced, experienced and respected suppliers and a relatively limited number of sophisticated commercial purchasers (including some of the largest companies in the world), the suppliers could have market power.[294] In the absence of collusion (which is not suggested) or tacit coordination (which for reasons explained below[295] is not possible in this market) we are not aware of any credible economic theory that suggests that market power is likely in such circumstances, and there are numerous examples of competitive markets served by four – or indeed fewer – leading competitors.

7.4 PwC and other large audit firms have invested over time in developing their people, systems, methodologies, industry expertise and international networks to be capable of offering the quality and value that large companies require. This reflects the business models and strategic objectives of the largest audit firms. The mid-tier accountancy firms have adopted different business models and have other objectives and their levels and types of investment have reflected this. It is misconceived to assess competition as being between the largest four firms on the one hand and the mid-tier on the other and then to reach the conclusion that, because the mid-tier have not made investments of the kind necessary to offer an attractive proposition to the largest companies, this demonstrates that the market is not competitive.[296] What matters is the level of competition between those audit firms who do operate in the large company audit market.

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291 References to paragraphs in this section of the submission are to those in the Issues Statement, other than where it is to a paragraph "above", being to a paragraph earlier in this submission. We have in this section identified every paragraph of the Issues Statement to which this section responds, except those paragraphs which are merely introductory or do not contain substantive points (i.e. paragraphs 1 - 8, 11, 12, 15, 23, 24, 34, 42 and 50).

292 At paragraphs 11-20.

293 Paragraph 23.

294 Paragraph 9(b).

295 Paragraphs 7.39 - 7.42 below.

296 Paragraph 26.

7.5 The misconception arises in part if undue weight is given to the degree of concentration in the market as measured by simple descriptive statistics such as the HHI[297], and there is insufficient regard to the evidence of what actually happens in the market (which we appreciate has not been available to the CC until now). Balancing observations as to the degree of concentration with understanding of actual competitive dynamics is in line with the CC guidelines on market investigations which state: "*Where it uses the HHI, the Commission will have regard to the threshold levels set out above, but only as one factor in its wider assessment of competition.*"[298]

7.6 Simplistic reliance on measures of concentration such as the HHI are particularly unhelpful in a market which has been defined to contain a very limited number of customers where, for the HHI to be of any value as an analytical tool, it is necessary to consider the actual value against the theoretical efficient number of suppliers given the size of the market. This is made clear by a simple hypothetical example. Consider two markets (A and B) each with two suppliers. Suppose that in market A there are only two customers whereas in market B there are several million customers. The HHI will be the same in both markets suggesting a very high level of concentration, but the competitive conditions in the two markets and the scope for efficient entry or expansion are very different. In large company audit markets we have at least four audit firms currently supplying a limited number of customers.[299] This differs markedly from, say, four main banks or supermarkets supplying the entire population of the UK.

7.7 In any case, we have a number of other concerns about the calculation and use of the HHI by the OFT and relied upon by the CC in the Issues Statement, and in our view if the HHI is calculated appropriately it demonstrates that the FTSE 350 audit market is only moderately-concentrated. Our analysis is set out in full in Annex 9.[300]

7.8 Of far greater relevance than the HHI calculations is the evidence of how the large audit firms compete against each other and how large companies exercise their considerable buyer-power to achieve improvements in audit service levels and price by implicitly or explicitly threatening – and sometimes requiring – a tender process. This is described in section 5 above.

7.9 While the largest audit firms have invested over time and have sunk costs in systems, talent, methodologies and international networks, the process is dynamic. It is not a case of the largest firms investing in order to achieve an established market position and then standing still and reaping the rewards. Continuous investment and improvement are required to ensure that the needs of the large companies are properly and efficiently met so that the investing audit firms individually retain and win business. We explain (in paragraphs 3.35 - 3.39 and 4.24 - 4.28 and Annex 6) our efforts to differentiate our audit service and our recent investments in Aura, GADM, our VwC initiative and in delivering the PwC Experience.[301] There are also ongoing cost increases investing, retaining and training talent and maintaining the efficient operation of the global network of firms.

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297 HHI analysis is of more value in merger analysis when one is seeking to anticipate future events post-merger than in a market investigation where one is examining current market conditions and there is other evidence available as to competitive conditions. It is noted that the OFT guidance on market investigations (March 2006) does not refer to HHI measures at all.

298 2003 guidelines, paragraph 3.11.

299 In banking there are currently three audit firms supplying just five banks.

300 Paragraph 25.

301 Paragraphs 14, 20, 28 and 29.

Competitive tensions

7.10 The continuing competitive tensions are demonstrated in particular by the following:

(a) There have been movements in market share between the four largest firms in recent years, with (most notably) Deloitte's share of the FTSE 350 growing from 13% to 25% since 2001.

(b) There is continuous "churn" of companies in and out of the FTSE 350. Of the companies making up the FTSE 350 in 2001, only 167 (48%) were still in the FTSE 350 in 2010. In order for us simply to maintain our market share in the defined market we must continually fight to retain our existing audit customers and to win business from growing companies which enter the FTSE 350. In order to grow, which is our objective (and the stated objective of our main competitors), we need to target and win audits from our competitors.

(c) There is regular M&A activity among the FTSE 350 where, if the merging companies have different auditors, at least one of the existing auditors will lose business. It is not necessarily predictable as to when such activity will take place and who the merger partners will be. Each audit firm knows that it must offer superior quality and efficiency in order to maximise the chance of its appointment in the case of a merger.[302]

(d) There is regular discussion between companies and their auditors about quality and value. We are aware that our audit customers compare us against other auditors using experience from other directorships held or previous employers; benchmark our fees with those of analogous audits using readily available data in annual reports; receive "cold" offers from rival audit firms; and negotiate hard on audit scope and fees every year. Our appointment is ratified by shareholders annually and the threat of tender if we take our "eye off the ball" is always present. The evidence we set out in this submission demonstrates how seriously we take the risk of the companies that we audit changing audit firms and how we plan to win business from our competitors.[303]

Concentration in sectors

7.11 In response to the suggestion that in certain sectors (banking, mining and utilities) not all of the four largest audit firms have the same level of specialist knowledge and sector expertise[304]:

(a) Developing the knowledge and experience to be recognised as expert in these sectors is one way in which an audit firm can distinguish itself from its rivals to offer a more competitive service to such large companies. Our commitment to be well-known as having deep industry knowledge and specialism is one way of demonstrating to the wider large company audit market that we provide the best level of service. However, such an approach is not confined to the sectors identified in the Issues Statement – developing and demonstrating industry knowledge and experience across the board is an important

302 Paragraphs 14, 20 and 32.
303 Paragraphs 14, 18, 19, 20 and 32.
304 Paragraph 30 (and paragraph 9(c)).

competitive attribute[305]. We compete in all industry sectors and we are not aware of any sector in which companies have no choice of audit service provider. We are not aware of any sector in which all four of the largest audit firms could not offer a competitive service if opportunities should arise.

(b) Those large firms that do not have such a strong current audit presence in a particular industry have the means and ability to develop that knowledge and experience (for example, by bringing in specialists from other parts of their networks, expanding from an "inbound" audit client base, and by building up a specialist team through investment and lateral hires)[306].

Barriers to entry

7.12 To the extent therefore that the largest audit firms are able to offer to some large companies a service that cannot be technically matched by the mid-tier firms, and more generally a quality matching the needs of large companies and providing better value, this reflects differentiation and the outcome of the competitive process. This process has not reached an end, but continues on a dynamic basis as competition applies itself between the largest firms.[307]

7.13 The role of barriers to entry in the analysis is not to determine initially whether there is market power but rather: *"Where the Commission believes that intra-market rivalry is not strong, other possible competitive constraints on firms need to be considered… The threat of entry or expansion can act as a constraint, preventing firms from exercising market power"*[308]. Thus, where the evidence indicates effective intra-market rivalry, which we believe it does, the existence or otherwise of barriers to entry is irrelevant.[309]

7.14 The fact that the mid-tier firms do not possess the same attributes as the largest audit firms should not disguise the fact that the mid-tier firms are significant sized businesses and operate effectively in the part of the market that they have chosen to serve. They have the attributes necessary to audit (and provide a wide range of non-audit services to) a large number of companies, including some in the FTSE 350. They also have the skills and resources required to ensure that they are able to make their abilities known to potential clients.[310]

7.15 Where a mid-tier firm does have the attributes to audit a FTSE 350 company, that company will have a choice between the mid-tier firm or a larger audit firm. In such circumstances the company will consider the relative skills and experience of the mid-tier firm and each of the larger firms, the prices offered and the comparative quality, and make a decision. The Issues Statement suggests[311] that in such a situation a company may choose to appoint a larger audit firm because of market perception, even if it considers the larger firm proposition to be of lower quality and to offer less value than the mid-tier firm. This suggests an unrealistic degree of

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305 See the submission to the CC in relation to this inquiry of a paper dated October 2011 by Evans and Schwartz entitled *"Was it Market Power or Sarbanes-Oxley? An Analysis Using the Workhorse Audit fee Model and Panel Data Techniques";* http://www.competition-commission.org.uk/inquiries/ref2011/statutory_audit_services/pdf/jeremy_schwartz_phd_and_lawrance_evans_jr_phd_was_it_market_power_or_sarbanes_oxley.pdf. While we do not agree with all of the findings in this paper it is noted that the authors concluded that an audit by an expert can produce an audit at lower cost.

306 See paragraph 4.63(b) above.

307 Paragraphs 14, 20 and 28.

308 CC Guidelines, paragraphs 3.16 - 3.17.

309 Paragraph 29.

310 Paragraphs 21 and 22.

311 Paragraph 27.

irrationality on the part of the company and the markets. We are not aware of any evidence to support this position and consider that where companies appoint a large audit firm, even where a mid-tier firm may be technically capable, it is because the large audit firm offers better quality and value.[312]

7.16 There are similar reasons why some (but not all) smaller companies that have newly entered, or are on the cusp of entering, the FTSE 350 switch from a mid-tier firm to one of the four largest firms. Such companies are looking to appoint an audit firm that is capable of supporting their growth ambitions. This might be internationally into new countries, by acquisition into new sectors and/or more generally in terms of the improvements required to their financial operating systems to ensure that they become best-in-class.

Efficiencies

7.17 The investment by PwC and other large firms in resources, experience, methodologies, relationships and international networks (and the systems to utilise these attributes) gives rise to significant sunk and other costs which in some cases are client specific but in the most part are available across the client base including for smaller companies, who may not necessarily need all of these resources but nevertheless benefit from the efficiencies and quality to which they give rise. While recognising the potential for such efficiency benefits the Issues Statement states: "*Nevertheless, even allowing for such factors, the quality of an audit might be lower, and the price higher, than in a less concentrated market*".[313] This is not the case for the following reasons:

(a) As explained above there is effective competition between the largest firms and this ensures that quality and prices are at a competitive level.[314]

(b) The relevant market has a relatively small number of companies (and even if a global market is taken into account the number of potential customers is very small compared to a consumer market). In the light of the significant investment required it cannot be assumed that a larger number of suppliers would lead to a more efficient outcome and lower costs per client as economies of scale would be lost.[315]

7.18 The effectiveness of competition within the present market structure is demonstrated by the market outcomes – competitive prices, high (but not "gold-plated") quality and continual innovation.[316]

(b) The four largest firms could bundle together services in order to create barriers to entry in the market for statutory audit and in related markets

There is no bundling

7.19 This theory of harm suggests that the four largest firms could bundle together services "*<u>in order to create</u> barriers to entry in the market for statutory audit and in related markets"* [emphasis added]. We vigorously reject any suggestion that we seek to create such barriers to entry.

312 See section 3D above.
313 Paragraph 32.
314 Paragraphs 14, 18, 19 and 20.
315 Paragraph 19.
316 Paragraph 20 of Issues Statement and section 6 above.

There is no evidence to suggest this is the case. Audit services (which comprise statutory audit and audit-related services[317]) are sold together, but all other services are sold separately. There is no question of bundling in relation to audit-related services as there is no practical alternative to these being supplied by the auditor: they are very much part of the "audit service" and the applicable Ethical Standard makes clear that these are services "*closely related to the work performed in the audit and the threats to auditor independence are clearly insignificant and, as a consequence, safeguards need not be applied*".

7.20 In fact, as the Issues Statement indicates, certain types of bundling of audit and non-audit services are not permitted under current regulations.[318] Therefore, to the extent that companies choose to acquire both audit and non-audit services from us, it is because those companies consider that we offer an attractive competitive proposition in respect of both types of service in their own right[319]. Some audit-related services (e.g. regulatory reporting) will typically be acquired from the audit provider as the auditor's understanding of the business means there are considerable synergies in it undertaking this work, and thus is the logical and cost-effective choice for the customer.

7.21 In any event, the bundling of services across the market would only be possible (and would certainly only be harmful) if the four largest firms had market power - which, for the reasons described above, is not the case. In the absence of market power it is open to companies to insist on the separation of services to the extent that they were being artificially bundled.[320]

7.22 In fact, the independence requirements imposed by regulation or insisted upon by companies mean that the value of non-audit services which large audit firms provide to their large listed company audit clients is in steady decline. Figure 16 below illustrates that the ratio of non-audit services to audit services provided to our audit clients has declined significantly over the last five years.

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317 The provision of audit-related services is covered by the APB Ethical Standard 5 (revised) *Non-audit services provided to audited entities* under the International Standards on Auditing (ISA). (Section Application of general principles to specific non-audit services - Audit related services - paragraphs 54 - 57):

"54 Audit related services are those non-audit services specified in this Standard that are largely carried out by members of the engagement team and where the work involved is closely related to the work performed in the audit and the threats to auditor independence are clearly insignificant and, as a consequence, safeguards need not be applied.

55 Audit related services are:

- *Reporting required by law or regulation to be provided by the auditor;*
- *Reviews of interim financial information;*
- *Reporting on regulatory returns;*
- *Reporting to a regulator on client assets:*
- *Reporting on government grants;*
- *Reporting on internal financial controls when required by law or regulation;*

Extended audit work that is authorised by those charged with governance performed on financial information and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions.

56 The audit engagement partner shall ensure that only those non-audit services listed in paragraph 55 are described as audit related services in communications with those charged with governance of the audited entity.

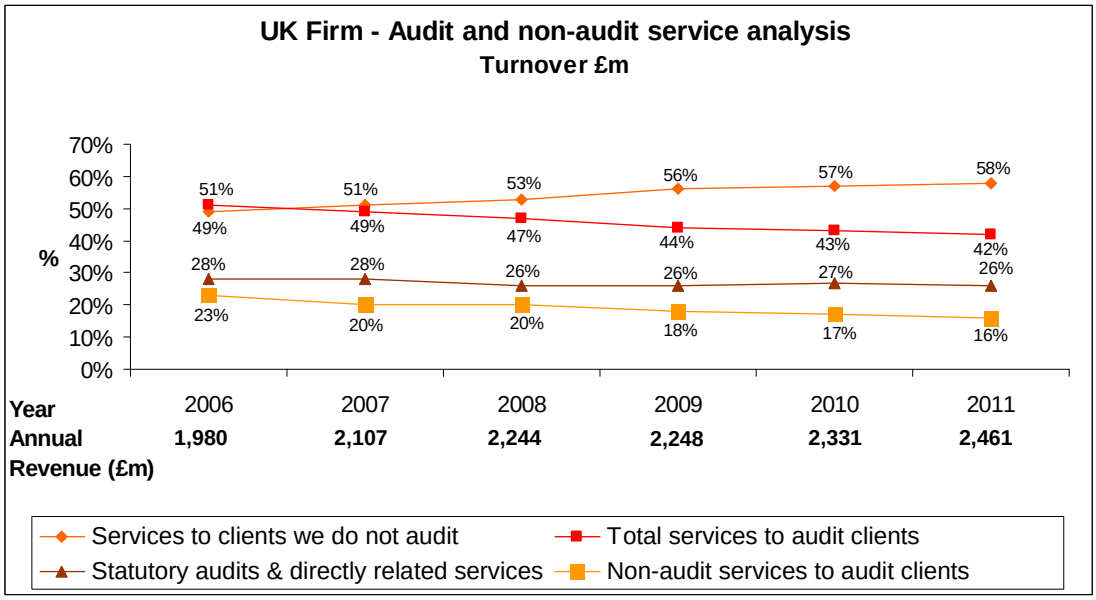
57 There may be other services that the auditor considers are closely related to an audit. However the threats to auditor independence arising from such services are not necessarily clearly insignificant and the auditor considers whether such services give rise to threats to independence and, where appropriate, the need to apply safeguards."

318 See section 201 of the Sarbanes-Oxley Act and the Ethical Standards set by the UK Auditing Practices Board.

319 Paragraph 9(e).

320 Paragraph 37.

Figure 16: PwC UK proportion of revenues from audit and non-audit clients[321]



7.23 For FTSE 350 companies our data show that on average we earn more non-audit fees where we are not the auditor than we do where we perform the audit.[322] This implies the opposite effect from that suggested by the CC's theory of harm related to bundling.[323] By being engaged as auditor, far from being able to bundle non-audit services to leverage the audit engagement into those markets, we are required to reduce our non-audit activity, opening up opportunities to other suppliers in those markets.[324]

Circumstances in which our audit and non-audit businesses serve the same client

7.24 There are a number of circumstances in which services from our audit and non-audit businesses may be provided to the same client[325]:

(a) As explained above the company may choose to buy more than one service from the audit firm. Companies have a choice of provider in audit markets and in non-audit markets. The competitive conditions in audit markets are explained throughout this submission. As for non-audit markets, we face considerable competitive pressure from other accountancy firms, law firms, insolvency practitioners and a wide range of other consultancies. While a company may find it attractive to acquire more than one service from us because we know their business and how it is structured across the world, this is not because of bundling but because we are able to offer the most attractive proposition to the company for each of the services in question.[326] The existing independence restrictions imposed by regulation and companies' internal governance rules ensure that

321 See page 13 of the PwC UK 2011 Annual Report.
322 See paragraph 4.57 above, and Figure 9.
323 Paragraphs 22 and 35.
324 It also follows that it would not make sense for us to seek an advantage in bidding for an audit appointment on the basis of somehow seeking to "bundle" our non-audit service capabilities (notwithstanding regulations preventing this), because the reality is that if the client did value such non-audit capabilities it would be less likely to want to appoint us as auditor and thus have reduced access to these capabilities.
325 Paragraph 33.
326 Paragraph 38.

the audit firm does not also provide a service which might compromise its independence.[327]

(b) As part of the delivery of a quality audit it is nearly always necessary to call on the services of other experts within the firm - for example, tax expertise is usually required in order to assess whether tax assets or liabilities have been properly accounted. This is not bundling but the use of internal expertise as an integral part of the audit. Similarly there are other specialists such as controls assurance specialists who evaluate the company's financial operating system in order to allow the audit team to assess the degree to which they can rely on the results from that system. Such work, as we have explained in detail in Annex 5, is a necessary part of the audit.

Audit-related services

7.25 Arising out of the audit, the audit firm is in a position to advise the company's management and audit committee on a number of matters, for example how the company's internal controls compare to those of similar companies. While providing such a service may not strictly be part of the statutory audit it involves limited incremental cost (given that the substantive work of testing the system has already been completed, and only the benchmark analysis needs separately to be performed) and has a value to management and shareholders that far outweighs the cost. If a company did not wish to receive such a service from us we would not insist on it. This is not bundling, but the company seeing direct value and efficiency in receiving additional insight from its audit provider given the low incremental cost and high incremental value in having such services provided by a firm which already has an intimate understanding of the company's business.[328]

7.26 We note in this regard the reference in the Issues Statement to the Oxera report which stated that the four largest firms were perceived "*to be better placed to offer other services, so that the four largest firms and mid-tier firms were not seen as substitutable in this respect*".[329] The Oxera report described these services as "value-added" services and the report makes clear that these services are highly valued by clients "*as they obtain certain insights as to how their company is performing (and a degree of comfort from this)*"[330]. As the quotations from the Oxera report make clear, where clients acquire these services from the largest firms it reflects the client's assessment of the provider which is better placed to provide the service.

Benefits to an audit firm of non-audit services

7.27 Overall, the presence of strong non-audit capabilities within a firm like PwC has a wholly positive influence on the quality and competitiveness of audit services:

(a) Non-audit specialists provide vital input into quality audits, but are only available to us in-house because they are able to spend most of their time honing their expertise and maintaining their practice on non-audit work.

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327 Paragraph 21.
328 Paragraph 35.
329 Paragraph 36.
330 Paragraph 3.1.1 of the Oxera report.

(b) Where non-audit services are permitted for audit clients, those clients have access to multi-disciplinary teams with exceptional knowledge of the client's business. This can be attractive and valuable for audit clients in the case of some non-audit services.

(c) The presence of non-audit services within our firm gives us cost and quality benefits in the supply of audits, for example: by making it easier for us to attract talented individuals who value having options to develop their careers outside of audit should that be their later choice; by spreading the costs of recruitment and training across a wider number of people; by reducing our reliance on audit, making it easier to cope with fluctuations in that business and to bear liability risks; and strengthening our capacity for independence by making each individual audit fee smaller relative to our total fees.

(d) Large companies who are not currently PwC audit clients have the opportunity to experience what it is like to be advised by us. This increases their understanding of our attributes as a competitor to their existing audit firm.

7.28 For these and other reasons we have chosen to provide a broad range of business services which we regard as complementary and a natural fit with our historical origins in audit.

International services and global audits

7.29 The Issues Statement suggests that there may be a bundling of statutory audits for a parent company with its partners or subsidiaries.[331] As large companies have expanded internationally, they have chosen to use a single network with common standards, methodologies and systems for their group audit rather than rely on local audit firms in different countries. This has been driven by the companies, and the development of global audit networks has reflected the value placed by such companies in using a single global network for their audit. A single coherent network reduces the risks of mistakes being made (the adverse effect of which can be very substantial), ensures a more consistent methodology is applied throughout the corporate group and results in a more efficient and therefore cost effective service. There are cost, quality and efficiency advantages in having a single audit network for a global audit responsible for the overall opinion.

7.30 The benefits of instructing the same audit network for the worldwide audit have been recognised by The Hundred Group of Finance Directors.[332] This benefit is reflected in current regulatory standards[333] which have been interpreted by large companies as effectively requiring the company's group audit firm to audit the majority of the group's subsidiaries.

(c) Customer conduct limits competition, in particular by tendering infrequently

7.31 This theory of harm fails to appreciate the focus of customers on achieving competitive outcomes and their success in doing so, and gives undue emphasis to the frequency of tendering as the means of achieving such outcomes. The internal process through which large companies select their auditor involves more scrutiny and a higher level of corporate governance than for any other business service. There is transparency as to audit fees, and

331 Paragraph 37.

332 Hundred Group submission to the House of Lords Economic Affairs Committee, 27 September 2011 at http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10120702.htm.

333 ISA600: Special Considerations - Audits of Group Financial Statements (including the Work of Component Auditors).

customers are well informed and exert significant pressure on audit firms in respect of quality and value. This pressure is backed up by the very real threat of tendering and switching.

7.32 As to the suggestion that switching costs may drive low levels of tendering and switching[334], we believe that switching costs may be one factor in a company's decision not to tender or switch unnecessarily[335], but:

(a) The levels of tendering are not as low as Oxera suggests in its survey in 2006[336] and the number of switches are not as low as the OFT suggests in its Decision[337]. Further there is considerable churn of membership of the FTSE 350 arising from movements in and out and merger activity which give opportunities to win (or lose) business.[338]

(b) Large companies have the option of appointing an alternative audit firm and tenders occur with sufficient frequency and across a sufficiently large number of companies that no audit firm can afford to be complacent. This threat of switching means that companies do not need to incur the time and expense of conducting regular tenders. The dynamic process of regular discussions between company and audit firm – which occur annually and can be particularly pronounced every five years with the rotation of the lead partner - is described in detail in section 5 above. Notably, this includes the audit committee being required to review auditor performance and make a recommendation to shareholders at the company's AGM every year in relation to the appointment decision.

(c) Each FTSE 350 audit contract is of substantial value to the audit firm, particularly taking into account the likely length of the relationship, and losing (or winning) one will impact on the audit firm's market reputation. This, combined with the knowledge that a tender is an ever-present prospect (with the uncertainty of timing of any tender an additional pressure), provides a strong incentive to ensure that the audit firm remains responsive to the company's needs.[339]

(d) In our experience, audit firms compete very strongly for tenders, whether seeking to defend an existing mandate or win a new one. We describe in section 4C above the very considerable efforts that we go to in order to win audit tenders.

(e) The principal reason that a company may choose not to tender is not a desire to avoid switching costs: it is the benefit of a long-term audit relationship.[340] There are significant mutual benefits for the company and the audit firm in building such a corporate-level relationship while partner rotation rules and regular changes of board and management personnel at the company protect against over-familiarity at a personal level. The better an audit firm knows a large company's business, the more likely it is that the audit firm will be able to provide a high quality audit service. Risks can be identified earlier; difficult judgements can be made more efficiently; the prospect of spotting internal fraud is enhanced; and the audit firm is well-placed to assess the audit impact of the integration of

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334 Paragraphs 40 and 41.
335 See, for example, the experience of the switching process for those companies referred to in section 5E above.
336 Referred to in paragraph 9(g) - see section 4A above.
337 Referred to in paragraph 9(f) - see section 4A above.
338 See section 4A above.
339 On the other hand it does not compromise independence or quality. No one client is worth the reputational impact of compromising on these attributes.
340 See also paragraph 4.47 above.

any new businesses or expansion into new countries. However, to succeed in developing a long term relationship requires the audit firm to deliver a consistently high standard of service, which is recognised as being good value for money. Only then can the audit firm expect to be re-appointed.[341]

(d) Specific features of the market may make it particularly prone to risks of regulatory failures which could lead to a reduction or distortion of competition in the market

7.33 Regulation plays an important role in the way the audit market operates. It influences the nature and delivery of the audit service and, to protect the auditor's objectivity, restricts the range of services that can be provided by an audit firm to its audit clients. We explain the operation of the regulatory system in Annex 2. We believe that the regulatory system achieves its objectives and therefore there is no regulatory failure. Further, while the regulatory system can and should evolve to meet the demands of the corporate reporting world, it is not the case that the current regulatory system has the unintended adverse consequences outlined in the Issues Statement. We respond below to each of the three potential concerns outlined in the Issues Statement.

Undue influence

7.34 First, the Issues Statement suggests that the largest auditors can fund more persuasive submissions to regulatory bodies than others and this unduly influences those bodies or alternatively (or in addition) the regulatory authorities are overly influenced by the market shares of the largest audit firms[342]. Of course, we seek to have an informed and constructive engagement with the regulatory bodies to make our views known to them on issues of importance to the profession. This is done as part of our public interest mandate employing our detailed knowledge of the subject rather than an attempt to protect self interest. Our competitors do the same and sometimes representations are made as part of a group of the six largest firms. It is absolutely not the case that the European Commission, the ICAEW, the ICAS, the FRC or the AIU (or any other regulatory bodies) are susceptible to bending to the will of PwC or the other large audit firms. Sometimes our views are accepted and on other occasions they are not. There are regulatory decisions with which we disagree. For example:

(a) We argued against the assertions put forward by the FRC in their discussion paper on audit scepticism regarding "presumptive doubt" and the applicability of the referenced research material in support of it but this remains a theme that the FRC are pursuing.[343]

(b) Throughout the development of ISA 610 (revised) "Using the Work of Internal Auditors" we have debated the relevance of the risk of material misstatement to the external auditor's decisions regarding using the work of internal auditors, but this was included in the final standard [✂].[344]

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341 Paragraph 14.

342 Paragraph 43.

343 See Exhibit 141: Letter to JEC Grant, Financial Reporting Council on "APB Discussion paper "Auditor Scepticism: Raising the Bar" dated 29 October 2010.

344 See Exhibit 142: Letter to Mr James Gunn, Technical Director, International Auditing and Assurance Standards Board re "IAASB Exposure Draft ISA 610 (Revised) – "Using the Work of Internal Auditors" and related enhancements to ISA 315 (Revised) – "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" dated 16 November 2010.

(c) We disagreed with the AIU on the remuneration of "key audit partners" and direct assistance by internal audit.[345]

7.35 The above are a few examples of the involvement that we have in the standards and regulatory arena. These are in addition to our input to the development of accounting standards, both international and national. In this respect, we do not advocate regulatory standards that are inappropriately high or low, because ultimately our reputation depends on us taking a public position that is aligned with the interests of company shareholders at large, the public and the future integrity and credibility of the accounting and auditing profession.[346]

7.36 We also recognise that perceptions of audit quality can be influenced by the perceived credibility of the regulation-setting process. Key attributes of high quality regulation setting include transparent processes, widespread consultation and effective stakeholder engagement. Whilst we believe it is vital that audit expertise is brought to bear we recognise that public perception of the credibility of regulation is threatened if regulation setting bodies are seen as being dominated by the profession or if there are "reserved" seats for specific groups. We have therefore been supportive of reforms to standard-setting bodies designed to ensure that standards and regulation are recognised as being in the public interest. This is demonstrated in our response to the Monitoring Group of IFAC public interest reforms.[347]

Regulators and the largest firms

7.37 Second, the suggestion that the regulator might in some way "protect" or otherwise favour PwC or the other largest firms because of the fear that we might otherwise fail or exit the market[348] is incorrect and unsupported by any evidence. If anything, the profile of the largest audit firms means that they are likely to receive a stricter level of regulatory oversight than might otherwise be the case.[349] For example, each of the four largest firms is subject to an AIU report every year, whereas these are biannual or less frequent for smaller firms.

Regulators as a barrier to entry

7.38 Third, different stakeholders are likely to have different views on the optimal level of regulation. However, the suggestion in the Issues Statement that the level of regulation may influence the ability of mid-tier audit firms to audit large companies by biasing customer behaviour towards the "safe choice" in terms of reputation[350] is incorrect for two reasons:

(a) It assumes that an audit firm's "reputation" exists independently of the attributes that underlie that reputation. As explained above,[351] this is not the case: companies select large audit firms because of the attributes that the firms possess, not because of some undeserved reputation ungrounded in reality.

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345 See Exhibit 143: FRC Audit Inspection Unit public report on the 2007/8 inspection of PricewaterhouseCoopers LLP – response by PwC dated 24 November 2008.

346 Paragraph 43.

347 See Exhibit 144: Letter to Mr Hans Hoogervorst, Chairman, The Monitoring Group *"Review of the IFAC Reforms – Consultation Paper"*, dated 12 August 2010.

348 Paragraph 44.

349 Paragraph 44.

350 Paragraph 45.

351 Paragraph 7.15 above.

(b) Regulatory requirements do not impose a "ceiling" on the quality of audit that is required, or provide a full definition of what a quality audit needs to encompass. Meeting regulatory standards is a necessary but not sufficient requirement for an audit firm to be an effective competitor in this market. The fact that mid-tier audit firms are not normally selected to audit larger companies relates to the attributes possessed by the mid-tier firms in terms of skills, experience, systems, people and international network. It is not an outcome of more or less regulation but of the ability to handle complexity (which derives from the structure and operations of the company rather than regulation) and offer the quality (including judgement) required to conduct an audit of larger companies. So long as there is any system of statutory audit there will continue to be a distinction between different types of audit firm.

(e) Tacit coordination between the four largest firms results in less competition in certain sectors

7.39 The Issues Statement makes the point that *"Since the appointment of auditors is made by the audited companies, either following a negotiation or tender, tacit coordination on prices is less likely than some form of tacit coordination with regard to geography or industry sector"*[352]. It is entirely in the hands of the companies as to whether to conduct a tender and which audit firms to invite to tender so it would be no easier for audit firms to coordinate tacitly on choice of customer (or geography or sector) than on price. There are four large audit firms – all of which are well known to customers and therefore are likely to be specifically invited to tender if they are considered suitable. In this context, tacit coordination in relation to customers could only arise: (i) if, despite being invited to tender, the audit firm declined to do so (with the expectation that each of its rivals might decline to tender in subsequent cases where it felt itself to have a "preferred" position), or (ii) if the audit firm made specific efforts to make it known that it was not interested in certain sectors or geographic areas so that it was not invited to tender in the first place.

7.40 As explained above, there is significant competition between the four largest audit firms and we aggressively target rival firms' clients and have to defend our existing audit customers from the advances of our rivals across all sectors.[353] Furthermore, even for those customers that we are not actively targeting, if asked to participate in a tender for the audit, we would almost always accept and take the process seriously, recognising that to refuse and not to participate could seriously damage our relationships with the company and place at risk any non-audit services provided to the company.[354]

7.41 While there are occasions in which we have ceased to act or declined to accept an invitation to tender for a FTSE 350 client these have been for good objective reasons. These broadly fall into two categories:

(a) Situations where we saw the risk/reward ratio in acting as auditor to be unsatisfactory (i.e. because the risk of significant issues arising with the audit was seen as very high). This was the case, for example, with [✂].

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352 Paragraph 49.
353 See section 4 above.
354 See paragraph 4.55 above.

(b) Situations where, after discussions, the company and we mutually agreed that the company was better served by our providing non-audit services that would have to cease if appointed as auditor (the company determining in each case that it had sufficient choice of auditors). This was the case, for example, with [✂] and [✂] in the recent past.

7.42 This means that market conditions are not conducive to tacit coordination as described in the Issues Statement[355] and the CC's guidelines[356]. Other factors relevant to this conclusion are:

(a) There are not stable market shares for large listed company audits[357] and there is a difference in market shares between the largest firms. The other large firms, particularly Deloitte, are targeting our position as the leading global and UK audit provider.

(b) Demand is not stable. There is a constant churn of purchasers (companies entering and leaving the FTSE 350 and mergers), meaning there is no stability or predictability, making it impossible to coordinate customer selection.

(c) There are strong and well-informed purchasers, as we explain in detail in section 5 above. They are able to recognise competitive quality and price levels, and negotiate aggressively on an annual basis (as the CC recognises).

(d) While the four largest audit firms share the same essential attributes necessary to audit large companies,[358] they are structured differently in terms of their respective international networks; they have taken different approaches to ensuring a consistent global audit methodology; and they have embraced the effective delivery of certain audit tasks to different extents, for example, we have focussed in particular on innovation (in developing more efficient delivery models (notably through Aura and GADM)).[359]

(e) Even if one accepted that there were certain industry sectors in which certain audit firms are not particularly strong, the number of such sectors across the FTSE 350 as a whole is very limited. For all sectors all of the largest four auditors are currently credible alternatives, undermining the value and effectiveness of any attempt to partition a limited number of market segments.

(f) Client relationships tend to be long-term and of significant value over the life of the relationship, incentivising the benefit of winning a client.[360]

(g) Tenders are not frequent and the likelihood of any one company putting its audit appointment out to contract and the timing of such a tender is not predictable, making it impossible effectively to threaten retaliation.

(h) The largest audit firms have relationships (or aspire to relationships) with many companies in the FTSE 350. A refusal to tender for an audit would undermine such a relationship for both future audit and non-audit work.[361] Further, members of large

355 Paragraph 46 and 48.
356 June 2003, paragraph 3.66.
357 See section 4A above.
358 See section 3B above.
359 Paragraph 47. See Annex 6.
360 See paragraph 5.42 above.
361 See paragraph 4.55 above.

companies' management and boards tend to move from company to company and in some cases have multiple roles, so if a relationship is undermined in one company it could have a significant knock-on impact elsewhere.

(i) While there is transparency of audit price there is not transparency or predictability of audit scope which can change over the life of the relationship, for example as a result of a restructuring or acquisitions. This makes it hard for rival firms to assess the true value of the audit over the term of the expected relationship. Currency changes and how they impact a global audit service will also have a bearing on how easily prices can be benchmarked by rivals looking to monitor competitor performance.

(f) Information asymmetries and conflicts of interest adversely affect audit quality and allow the four largest firms to maintain market power

7.43 The Issues Statement suggests that there are two information asymmetries - being first, the ability of shareholders and others such as lenders to monitor the board of directors, and second, the ability of shareholders, the board of directors and the audit committee to monitor accurately the quality of an audit.[362] It also suggests that the interests of all the stakeholders in the process "*may not be perfectly aligned*".[363] We note that interests not being perfectly aligned is very different from there being "*conflicts of interest*" which is suggested in the heading to this section.[364]

7.44 We do not agree that there are either information asymmetries or conflicts of interest that adversely affect quality and, to the extent that different stakeholders have different perspectives or levels of knowledge, the regulatory system is designed to ensure that all relevant interests are taken into account and protected. Institutional investors and lenders are highly sophisticated and experienced organisations who understand the importance of the audit and regularly engage with the boards of the companies in which they invest on matters that they deem to be of strategic importance. They can appoint expert accountancy or legal advisers to advise them as necessary. Neither is there misalignment of interest between the investors and other stakeholders, including executive management (absent management fraud).[365] It is in the interest of all stakeholders to ensure that the company's financial statements are accurate and prepared in accordance with the highest standards - and the audit requirement is all the more important where there is any question of management fraud. It is also in the interest of all parties to ensure that the company has the benefit of high quality audit related advice and support from the audit firm because this ensures that the company is more likely to operate efficiently and thus give value to investors.

7.45 The Issues Statement states that auditor independence should provide assurance to the shareholders (and outside stakeholders, including debt providers) that a company's financial statements provide a true and fair view of its performance.[366] The very purpose of the audit report is to provide such assurance to shareholders (whether or not outside stakeholders rely on it), and auditor independence is a necessary requirement for auditors to be able to fulfil that

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362 Paragraph 50.
363 Paragraph 56.
364 A conflict of interest arises where a party has duties to one person which may conflict with its own interests or duties owed to another person.
365 Paragraphs 56-57.
366 Paragraph 51.

role. However, independence is not in itself sufficient to deliver a quality audit, for which the auditor must have the skills and experience required. It is suggested in the Issues Statement that this purpose might be prejudiced by the following factors:

(a) there may be information asymmetries between the audit firm on the one hand, and shareholders, the board and audit committees on the other hand, because of the technical complexity of the audit. This might mean that the former cannot determine the quality of an audit.[367]

(b) This might lead to the company appointing one of the four largest firms because of the largest firms' reputation.

(c) The company then not tendering the audit often because of the reliance on reputation and a lack of audit firms with such a reputation, leading to a lengthy working relationship between the audit firm, management and board which may compromise the independence of the auditor and the quality of the audit.

7.46 We reject each of these suggestions:

(a) Management, the board and the audit committee are more than capable of assessing the quality and value of the audit. While the finance director and the audit committee may not be involved in the precise application of the accounting standards and do not oversee every aspect of the audit process, this does not mean that they are incapable of assessing the relative strengths and weaknesses of an audit team and taking an informed view as to the overall quality of the audit service[368]:

(i) The finance director and members of the audit committee usually have a background in other large companies and may have held (or concurrently hold) directorships in a number of other large companies.[369] They are invariably well-qualified and capable people, with considerable experience of dealing with auditors, often having a background in accountancy and sometimes audit work. They are supported by internal finance teams with further relevant experience.

(ii) This experience makes the audit committee and the finance director extremely well informed about the audit process and well capable of assessing: the suitability of the proposed audit plan; how effectively the audit was executed across the company's operations throughout the world; whether pertinent lines of investigation were followed thoroughly and with rigour; how effectively the audit team interacted with and challenged management; the commercial usefulness of recommendations to improve systems, benchmarked against similar companies; and ultimately whether the audit represented good value for money.

(iii) This expertise and experience means that the board and the audit committee are capable of assessing the performance of the existing audit firm. It also equips them with the skills to evaluate in any tender how well an alternative firm could

367 Paragraph 52.
368 Paragraph 52.
369 See paragraphs 5.12 - 5.13 above and Annex 8.

perform the audit,[370] and the evidence in paragraphs 5.39 - 5.41 above of how seriously large companies approach the tender process shows how carefully this ability is tested. This means that the board is capable of making a well-informed recommendation to shareholders, acting on the advice of the audit committee, on which audit firm should be appointed at general meeting.

(iv) The role of the audit committee is particularly important. It acts on behalf of the shareholders (to whom the auditor owes a duty of care) and must be satisfied that the audit team has been sufficiently challenging of management in carrying out the audit. Figure 1 of the Issues Statement is deficient in not recognising a link between the audit committee and shareholders.[371]

(b) We explain above[372] that the reputation of the largest audit firms is built on the attributes and experience possessed by the firm. In a market with well-informed and sophisticated purchasers, advised by experienced accountancy and procurement professionals, the purchasers would not choose to instruct a firm of lesser quality over one of higher quality simply because the former had a stronger (unmerited) reputation.[373]

(c) Neither is it the case that the length of the working relationship between the audit firm and the company undermines independence. On the contrary, we believe that a long corporate-level relationship enhances the ability of an audit firm to understand the company and identify risks while independence is safeguarded by rotation of lead audit partners and other key staff. In any event, the reputation of an audit firm is of critical importance to its ability to win and retain business. This reputation is of greater value than the value of any one audit relationship, no matter how significant or long-lived.

7.47 The Issues Statement suggests that the reputational impact of poor audit quality "*may be vitiated by the protective effects of high barriers to entry and market power of the four largest firms*".[374] As we explain above,[375] the four largest firms are competitors and they do not possess market power. We are very much aware of the risk to our business arising from poor performance and the desire of other large audit firms to win audit work from us. Equally we look for opportunities to win business from our competitors.[376]

The failure and exit of one of the four largest firms

7.48 We note the intention of the CC to investigate the possibility of the future failure and exit of one of the four largest firms.[377] As the CC recognises, such events and their consequences are very difficult to predict.[378] Such an exercise is therefore different from the exercise normally involved in a market investigation, which is an investigation of the current features of the market and their impact on competition. This is clearly what is envisaged by the Enterprise Act 2002 which requires the CC to investigate the market as it is at the time of the investigation - that is,

370 Paragraph 53.
371 The audit committee members are accountable to shareholders, being subject to annual re-appointment. Institutional investors are well able to exert pressure if dissatisfied with their performance, including in relation to the audit.
372 Section 3 above.
373 Paragraph 53.
374 Paragraph 55.
375 Paragraphs 7.3 - 7.18 above.
376 Paragraphs 54-55. See section 4 above.
377 Paragraph 58.
378 Paragraph 60.

"*whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition…*".[379] There is a good reason for this focus on the current operation of the market. A forward looking analysis is more akin to that conducted in a merger inquiry. In this case, it would need to involve an assessment of counterfactuals and probabilities, including how the merger control authorities and other regulatory bodies would react to such a situation.

7.49 In the absence of any guidance from the CC as to how it would propose to carry out such an inquiry in the context of a market investigation we can, at this stage, only give very broad comments on what is proposed.

7.50 We do not believe that the risk of the failure and exit of one of the four largest firms is sufficiently likely that this potential future event should itself represent an adverse affect on competition. The changes in regulation made following the failure of Arthur Andersen, which we have described in detail in Annex 2, and the changes in the structure and conduct of the four largest audit firms and networks, mean that the likelihood of another large audit firm now failing and exiting the market is significantly less likely. We describe in section 6C above the steps taken to ensure quality outputs.[380] We also recognise our responsibilities in this respect and are involved in active discussions with regulators around planning for such an eventuality to minimise harm to the wider economy.

7.51 To the extent that the CC does consider that it has the power to consider possible future developments, one of the issues it will need to address are the proposals of the European Commission to bring about significant regulatory change[381] which would have a significant detrimental impact on how audit firms conduct their business and consequences for audit quality, reliability and competition.

PricewaterhouseCoopers LLP

12 January 2012

[379] Section 134(1).
[380] Paragraph 60.
[381] See section 2G above.