

STATUTORY AUDIT SERVICES MARKET INQUIRY

Summary of hearing with PricewaterhouseCoopers held on 3 October 2012

Background

1. PricewaterhouseCoopers (PwC) was a limited liability partnership owned by its partners. On 1 July 2011, it had 843 partners. For its financial year 2011, the PwC group had revenues of £2,461 million and it employed about 17,000 people, 6,600 of these in Assurance. PwC was regulated by the ICAEW, the Financial Reporting Council (FRC), the Financial Services Authority (FSA) and the Public Company Accounting Oversight Board (PCAOB).

PwC opening

2. There was continuous competition on a day-to-day basis between PwC and other Big 4 firms. The purchasers of audit services were sophisticated, experienced individuals who knew how to discern price and quality and negotiated accordingly. These buyers held significant bargaining power. PwC gave an example where one of its clients, [redacted], recently expressed dissatisfaction to it. This led, in the space of four months, to a change of not only the lead partner but all of the senior audit team. Following this change, the client was much happier with the quality of service and price and did not see a need to tender. The hypothesis set out in the CC's first theory of harm of ineffective competition did not reflect the market in which audit firms operated. In PwC's view, the outcomes within the market—such as reasonable prices, profits which were not excessive, good quality and constant innovation—further supported this competitive position.
3. PwC also did not consider that there was a misalignment of objectives between auditors, audit committees and investors. There was too much of a risk to its reputation if it exploited its position in any way and the same applied to Audit Committees. It was very important that investors and the market as a whole were provided with relevant and timely information and PwC provided some examples where it had engaged with stakeholders to try to move the financial reporting agenda forward, including working with investors to improve corporate reporting, its Building Public Trust programme, its Assurance Today and Tomorrow survey and its work in helping the corporate reporting user forum develop. However, audit was heavily regulated and the public audit opinion was heavily regulated by auditing standards. PwC was working with regulators including the International Auditing and Assurance Standards Board and the FRC Lab, which it supported the evolution of, to see how audit reports could evolve.

Scale rates and recovery rates

4. In setting its scale rates, PwC first built up an understanding of its costs in terms of people, salaries and wider costs. It also looked at the market to establish a sense of market rates. It undertook the exercise of reviewing scale rates annually at the same time as it reviewed its pay round for the following year. It then set scale rates, taking account of its historical position. It viewed scale rates as sending a message to its partners of the level of changes to its underlying cost base. It regarded the previous year's level as in effect a floor and could not recall an occasion when scale rates had been lowered. [redacted]. PwC's clients tended to focus on what the hours were that PwC

would spend on the audit and how that translated into the overall fee and achieved rate per hour rather than scale rates.

5. To determine the price of an audit, PwC had an internal escalation procedure where an acceptable price was determined. Every year, partner objectives were set with respect to prices that partners should seek to achieve from their clients. There had been rare occasions when PwC had informed clients that it could not continue its engagement if the client was not prepared to accept a specific level of fees. Irrespective of the price, PwC would not compromise on quality.
6. This sort of conversation did not take place very frequently (where PwC would need to be clear with a client that if the price was not increased PwC would not continue as auditor), because in its view, its clients were aware of what the price for their audit should be. If its clients felt uncomfortable, they would solicit a price from another competitor. PwC gave an example where a company ([REDACTED]) was going through a light touch process of seeking proposals from three firms following which it would decide whether or not to conduct a full audit tender. [REDACTED] initiated a similar process, as did [REDACTED]. In a similar vein, [REDACTED] was interviewing potential partner candidates from the audit firms in preparation for a likely tender in 2013. PwC had decided not to continue to act for a FTSE 350 company on [REDACTED] occasions because the fee was too low and had ceased to act for [REDACTED] others on risk grounds.
7. PwC was unlikely abruptly to walk away from a client because the price was too low. Discussions on issues of this type were likely to take place over a number of years.

Partner remuneration

8. PwC partner remuneration reflected the mix of responsibilities that its partners had in the business and was calculated based on the total profits of the multidisciplinary firm. PwC did not have audit-only partners. Partners that conducted audits often also provided non-audit services to both audit and other clients and had other responsibilities in the business, for example in management. The remuneration also reflected PwC's significant intangibles built up over time from its reputation for quality, but PwC did not measure this. There was also an element to reflect the financial investment in the business that partners had made. It was a mixture of all these things that accounted for the £[REDACTED] difference between PwC's average market-based audit partner salary, which it had calculated using a methodology submitted to the CC,¹ and the average reward earned by its partners.

Rivalry and innovation

9. PwC constantly looked for an edge in how it delivered its audit service and how it reported to companies the findings from that service. Opportunities to innovate with respect to the public opinion were very constrained by regulation. Regulation provided a baseline that had to be met and generally companies were reluctant to go above and beyond the baseline for public reporting. However, PwC's reports to audit committees had changed significantly over the last five years, including communications around audit judgements and sensitivities in the accounts. Referring to one of its clients, [REDACTED], PwC was aware a few years in advance that the client would be tendering its audit business. Threat of tendering, which was not confirmed, led to

¹ See www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/pwc_observations_on_the_assessment_of_profitability.pdf.

significant innovation in the reporting for this client more than two to three years ahead of the tender.

10. In PwC's view, the audit market was all about: (a) what companies reported and the relevance of what they reported; and (b) the reliability of such reporting. With respect to the first point, PwC had spent ten years thinking and working with investors and others about how corporate reporting could be moved on and improved as demonstrated in its Building Public Trust initiative. It provided examples of where this had led or was currently leading to recent changes in reporting for some of its clients; for example, [REDACTED], which was looking to PwC to provide fully integrated annual audit opinions, and where, as an assurance assignment outside the audit, it had reported upon an environmental profit and loss (P&L) for another client, [REDACTED]. However, companies were cautious about being the first to break new ground in terms of reporting, but companies were starting to do this.
11. PwC looked to apply developments in other areas to audit. It gave an example of where it had been asked to pitch, along with others, to help a client with some fraud work. Its approach was distinctive [REDACTED] and through applying these techniques it had identified the fraud in issue and another as well. As a consequence, it was considering how it could use such [REDACTED] techniques to improve its audits. It was also looking for ways to innovate how it delivered its audit and provided an example of [REDACTED].
12. PwC tried to encourage Audit Committees to be more informative and transparent in companies' annual reports about the nature of discussions that they had had with the auditors. This had led to some Audit Committees (for example, [REDACTED]) taking a lead, which had been picked up by regulators and had influenced recent changes to the corporate governance code. PwC clarified that when a client looked for assurance in areas that were not required to be audited, it worked with such clients and companies to seek to find ways in which it might innovate its service, for example [REDACTED]. In order to give such additional assurance, PwC had to understand the workings of the business, the way its systems, controls and processes worked, and would typically comment on these to a client. Where PwC's reporting of its audit findings to the company and such innovations led to the implementation of new systems or processes, PwC would not act as management and implement such changes because of potential breaches to the independence requirements for an auditor. However, clients liked to receive from it independent assurance around issues which did not strictly fall under the audit as this created value for them.

Switching, tendering and marketing

13. Companies that tended to have long tenures were typically quite large international organizations that were quite often constantly changing and operated in complex areas. Switching auditor would be a challenge for them because a new auditor would need to become familiar with its operations and audit judgements. Such companies were likely to have sophisticated Audit Committees which were focused on continuing quality. PwC would expect such companies to be satisfied with the service they received from their auditor, although there would be some significant points in the relationship where it had had some difficult conversations which PwC worked very hard to manage and resolve. PwC gave the example of [REDACTED] as one such company (a PwC audit client). There were a number of checks and balances in PwC's audits of such companies, such as the audit partner on FTSE 350 company audits rotating every five years, and in large companies there was likely to be regular churn of directors and senior management so that at an engagement level the responsible individuals were regularly changing and therefore there was a dynamic series of changes under the surface. With another client, [REDACTED], where partner rotation had

recently occurred, the client seemed satisfied with the new partner in post but had expressed concerns about the audit director and one other junior member of staff and PwC was working hard to resolve this. The nature of the relationship was such that a client's first preference would be to attempt to resolve any issues rather than go out to tender because of the upheaval involved in changing auditor, although PwC noted that clients always had that choice. PwC gave the example of [redacted] where the client had opted to go to tender and ultimately PwC had been reappointed. Such conversations meant that audit relationships were continually being reset to ensure that quality was delivered. Clients had many options at their disposal to make sure they got the service they were looking for. PwC gave the example of [redacted], where PwC was required to change the team because the partner rotation had not worked. PwC made six commitments about what it would do to change things and it was measured a year later in relation to these by the Audit Committee.

14. It would be very unusual for PwC to be unaware if a client was considering going out to tender, and to that extent, as the incumbent auditor, it would have some time and opportunity to address any concerns the client may have. PwC would regard it as a massive failure if it was unaware that one of its clients was about to tender given the amount of work it did around customer care. It was PwC's view that the needs of investors were met better with an element of stability in the company–auditor relationship which had a healthy professional tension rather than constant change of auditor. This would allow the auditor to deliver a high-quality service, avoiding the need for a tender. This aligned auditors' incentives with those of investors. Investors required relevant, reliable information and PwC was focused on delivering this. PwC did not think shareholders would regard constant changes of auditor as very helpful. [redacted] went through a period where it tendered every three years but had now decided against doing that. PwC considered that the 'comply or explain' approach which already existed in the UK was a good solution and noted that the FRC was pushing this approach for tendering in its revised code. PwC considered that companies must be given flexibility to decide whether they wanted a change of auditor and noted that Singapore had reversed its mandatory rotation requirements for banks because it imposed changes at times which were not always right for the company.
15. An auditor's relationship with the management of a client had to be sufficiently trusting to ensure that management told the auditor where the risks were. The auditor had to form a judgement whether management was being sufficiently honest. If the auditor had any concerns, the auditor would have the option of going to the Audit Committee. The Audit Committee had to trust that the auditor would raise any issues with it if it had to. If there was not sufficient openness then the audit would not work.
16. Staff working on audits had higher utilization rates than their tax and advisory counterparts. This was because audit work was more predictable and the business would have a good indication of what volume was needed to be delivered ahead of time. Such staff would spend much less time on marketing and business development than in PwC's other businesses which could not predict every year that there may be a merger or acquisition or a piece of tax structuring to be put in place. While PwC's overall audit market share had remained relatively stable over time, there had been significant turnover in the composition of its market share and in the FTSE 350 index. There remained the unpredictability caused by changes in the risk profile within each audit due to changes in a company's systems, people or the nature of the business.

The tender process and choice

17. PwC's tender preparations generally included a review of accounting policies, particularly for companies that were mid cap or smaller companies which PwC con-

sidered required more frequent restatements. PwC said for one company, not in the FTSE 350, it would not accept the company's revenue recognition policy as part of its tender proposal. As part of PwC's Building Public Trust awards, PwC would provide to any company within the FTSE 350 an analysis of what it could see from the company's public reported information.

18. Some companies would find it disruptive to seek to have a choice of all of the four largest firms because of independence and conflicts of interest reasons. These concerns could be addressed. Companies had the ability to decide who they would want to bid in a tender and the ability to make any changes necessary to existing relationships to resolve any independence or conflict issues. For example, when PwC was invited to bid by [X] for its audit, it had discussions with it about how to manage the [X] funds held by PwC as investments. Notwithstanding the ability of companies to make changes if they wanted to, most companies would consider a tender between three contenders to represent a credible competition. PwC gave the example of [X] coming to it to ask about independence impediments in standing as potential auditors. [X] made it clear that its previous view of commercial conflict with [X] was no longer an issue since it believed that PwC could create separate teams with suitable information barriers.
19. Most audit firms would be given a relatively long lead in time to explore any issues that would need to be managed before making a formal proposal, although there were occasions when the auditor had to move very quickly, such as when there was a merger.
20. It was almost inevitable that certain sectors had higher concentrations of audit firms than other sectors. This was because firms operating in such sectors were likely to possess the requisite type of skills. However, it was important to recognize that such complex sectors were international markets so the large firms were able to import the required skills from other member firms to audit companies in the sector and to seek to win more mandates. PwC gave the examples of [X], where it had brought in partners from overseas. PwC discussed the position of the four large UK banks, two of which were audited by it and one each by KPMG and Deloitte. PwC considered that it would be quite unusual to end up with a perfect 1:1:1:1 relationship in any sector.

Annual renegotiations

21. PwC gave an example of a company, [X], which it said was becoming more common, using quite a formal benchmarking process, where companies solicited information from competitors to test any offer that they may have received from their incumbent auditor when they were annually reviewing their auditor contract. Some companies were using this as a precursor to deciding whether to go out to tender for the audit or not and [X] conducted a similar exercise. Many Audit Committee members benchmarked in a less formal way, relying on their multiple touch points of working with a range of auditors in their capacities as executives and non-executives for other companies. In addition, PwC spent a lot of time with Audit Committee Chairmen directly and the Audit committee had access to its reporting both directly and through the company's board and CFO and the company's finance organization which saw the auditor's work on a daily basis. Companies also analysed audit fee per pound of revenue using publicly available information. It was PwC's view that when companies said that they benchmarked their fees, they did so at any point along this spectrum of benchmarking.
22. PwC was generally able to submit quite accurate proposals in its tenders or other benchmarking-type requests. It sometimes found in the first year that there may be

issues that it was not made aware of or could not have been aware of. In such situations, it would take these up with the client for the following year. In general, PwC would be very reluctant to move away from any proposal it had put forward with respect to undertaking a new audit. The reason why year one margins were sometimes low was because of the nature of investment the firm needed in order to make sure that it had really understood a company's systems, processes and risks. PwC would normally look to price to reach satisfactory economics in its third year as auditors, and referred to a pitch it did for [REDACTED] on this basis.

Restrictions on entry and expansion

23. PwC considered that BDO LLP (BDO) and Grant Thornton UK LLP (GT) did compete for audit engagements at the bottom end of the FTSE 350. PwC also gave an example of GT competing for an audit mandate, [REDACTED], at the bottom end of the FTSE 100. They did not win any such tenders because their offer was not of the same nature as PwC's or of the other Big 4 firms. Ambitious FTSE 350 companies saw what the four largest audit firms had configured their businesses to do through choice and customers found that to be an attractive proposition. In certain niches, such as natural resources, some mid tier firms [REDACTED] had built up momentum and were able to compete better. Mid tier firms had made choices not to compete and invest in the same way that the four largest audit firms had and this was why they did not win many FTSE 350 audit mandates. Profits per partner at PwC's regional offices were likely to be quite similar to the likes of GT, BDO and Mazars LLP.
24. With respect to auditor clauses in loan documentation, PwC was often not aware of such clauses as they were between a company and a lender. PwC had publicly indicated that it did not support such provisions in any loan agreements.
25. Internal audit was a business activity that was very important to PwC and was an area that it competed in, including within the FTSE 350. PwC would be unable to hold an internal and external auditor role at the same time but an internal auditor role was one that it could very quickly unwind itself from were it to be engaged as the external auditor for an existing internal audit client.

Switching costs

26. As a new auditor, PwC occasionally found itself in the position of having to explain to an Audit committee changes it was seeking to a company's accounting policies or practices, or changes to its planned audit approach. This could be for reasons such as systems which it was told were consistent worldwide actually being bespoke and tailored to a significant degree on a territory by territory basis, as was the case with one of its clients, [REDACTED]. The highest risk of something being missed in an audit was in the first year end. Audit Committees understood this risk and understood that these risks, when going out to tender, were capable of being managed by PwC and the Audit Committee but the risk was inherent. Some companies, such as [REDACTED], sent out their judgemental accounting paper with the audit tender documents to try and militate against such risks.
27. The objective of five-year partner rotation, to introduce a fresh pair of eyes, was compatible with audit firms attempting to make the transition of a new partner 'seamless'. The incoming partner would have his/her professional pride and reputation at stake since they would sign the audit in their own name whilst having the benefit of the firm's detailed underlying understanding of the previous position. This, coupled with extensive internal quality review and Audit Inspection Unit (AIU) review, ensured that an incoming partner provided sufficient challenge as required. PwC could not think of

any significant changes that had been made by an incoming rotating partner. There were a large number of checks and balances in its audits and it was not just one person acting alone for a particular client.

Reputation as a proxy for quality

28. PwC's reputation reflected the continuous quality of its work, which was influenced in many cases by the most recent experience a client may have had with it. This is why it did so much testing of what its existing clients thought of its service, be that through PwC's various feedback processes, discussions or external measures such as brand health testing. If PwC did not demonstrate its capabilities, clients moved very quickly because they knew there were a number of other firms which would only too readily take the opportunity to demonstrate their capabilities. There was massive competition between the four largest firms. Outside the four largest firms, GT and BDO worked with many FTSE 100 companies in different capacities, almost all in a non-audit capacity. They were demonstrating their skills and the quality that they delivered as organizations. PwC considered that it was very important to demonstrate a range of services. To be competitive, firms outside the four largest firms needed to focus on those companies where they realistically had the skills to offer a competitive product at a competitive price.
29. Audit was a trust-based service. BDO and GT had the ability to build that trust and many who worked within these organizations trained at PwC or its predecessor organizations. The reason why BDO and GT had their AIU reports published alongside those of the four largest firms was to demonstrate that they were providing quality audits to their clients. However, together with the other three largest firms, PwC had certain features in which it had invested by choice that allowed it to create and offer a different product to sophisticated companies.
30. PwC would be very disappointed if it was completely unaware that a FTSE 350 company was putting its audit out to tender. It tried to maintain some sort of relationship with nearly every FTSE 350 company. It would be part of the role of certain people at PwC to know the state of play across companies in a particular sector. PwC encouraged partners and staff, setting specific targets, to develop relationships and credibility with companies as a potential provider of audit services. It tried to be reasonably targeted about where it built relationships in order to create an audit opportunity. It was probably matching the activity of other firms in terms of business development. It had tried to benchmark itself against other firms but had found it difficult to do so. All its partners undertook an element of business development activity, and when such activity stopped it noticed very quickly a negative return. A partner may be considered to be spending too much time on business development if the audit work they were leading on was not of a sufficiently high standard.
31. PwC held discussions with all partners every year about where they should spend their time. This included what business development activity they would undertake in the market area they worked in, including identifying specific companies that they would target. Such activities would be allocated an allowance of time within the partner's objectives. The partner would be expected in this allocated time to present PwC's expertise in the market in which the company operated to ensure that the company knew that it was standing ready if there was an opportunity with them. In PwC's experience, partners were readily given sufficient opportunities by senior company management on the basis that such executives expected to gain something from such meetings as well. This was connected with its reputation for delivering quality. It would be looking for any opportunities to work with the target company and this would include undertaking the company's audit.

Liability and banking

32. As an industry, audit firms faced enormous open-ended risks, and it was their duty to mitigate them. The major audit failures of the past were a wake-up call for the industry as they obliged auditors to not only get it right but to be able to demonstrate this to others. Over the years, PwC had seen the size and scale of claims diminish and the industry's management of the risks had become more sophisticated. For example, risk management had become a massive feature of the industry following some of the large claims in the 1970s and 1980s. Fundamentally, plaintiffs were essentially rational and wanted to recover their loss but at a level that was affordable rather than wanting to force audit firms to walk away from liability and face bankruptcy. [X]. The real challenge was the reputational risk rather than the actual financial risk from claims.
33. The financial crisis had not in and of itself given rise to litigation concerning the firm and PwC believed that its audit work was justified and appropriate. Although PwC had been part of the system that as a whole had failed, as a participant it needed to work to improve that system. Its reputation had not been tarnished by the recent financial crisis. This was because it was understood that auditors had performed audits appropriately and PwC was also undertaking a lot of work with the FSA, the Bank of England and others, which may not be completely visible to the press, but which was focused on improving the system. PwC was talking to them about the regulator's role as a prudential regulator, focusing on systemic risk and liquidity alongside its role as an auditor looking at the preparation of financial statements and companies' reporting to the market. PwC's reputation would have been damaged if it had behaved in an illegal or improper way, which it had not.
34. It was put to PwC that, with respect to audit, its commercial risk was reasonably low since it had visibility of the volume of its workload and that its litigation risk had been mitigated over the years by various risk management steps that it had put in place. In response, PwC noted that whilst the volume of audit work was stable, prices were declining. The challenge for auditors as a profession, if they wanted to start recovering prices and margins, was to find a way of making audits more relevant to the future needs of capital markets. One of the constraints of doing this was the increased risk of litigation associated with voluntary additional reporting. One of the reasons audit firms had been more effective at managing their risk than their exposure to liability was the clarity about what an audit was and planning around that. As regards litigation risk, there was a historic legacy concern around those risks and the insurance market was generally still taking the view that it was not commercially a risk that they were prepared to cover.
35. The work PwC was undertaking post the recent crisis was a demonstration that it was doing everything it could in the circumstances. The test an auditor was subject to, in litigation, was to show that the auditor 'fell below the professional standard' as set out in the auditing standards. [X]. In any audit failure PwC could face a civil action from the plaintiff and a second action from its regulator where its work would be reviewed by other professionals.

Shareholders

36. PwC accepted that the purpose of audit was to provide assurance to and report to shareholders. It talked extensively to investors about the nature of audit and the challenges it faced and it was also very interested in investors' views. It commented on some of the innovations it had been working on including regular 'auditors' views' sessions between senior auditors and groups of investors. PwC was constrained by

law from communicating any price-sensitive information on company-specific matters to any individual shareholder. It could only communicate to investors collectively. As a result, its practice was that individual shareholders should not be speaking directly with audit teams. PwC considered that investors should be questioning their representatives in a company, ie the Audit Committee, on specific audit matters to whom PwC could answer. Investors seemed to consider this quite an attractive option. Engagement with investors was possible at public forums or events such as AGMs, where PwC was available to answer questions; however, such events were managed and chaired by the relevant company which determined PwC's role. It would be more fruitful to encourage developments such as more comprehensive Audit Committee reporting. In this area, PwC had approached all FTSE 100 companies two years ago and encouraged them to report more comprehensively in their Audit Committee reports. Six companies had progressed this and the FRC's revised code further encouraged this. In PwC's view, only a few companies had moved in this direction because companies were evaluating the risks and rewards for doing so. Companies were concerned with being the first movers and stepping out of line with the rest of the market. This was not a market where companies thought it was good to differentiate oneself by stepping out of line, possibly for fear of litigation, particularly where companies reported to the US market. For example, a company may be fearful of listing its top five risks because number six on its list might be the one that brought it down.

37. Investors also recognized the importance of audit and they, at the same time as wanting more information, did not want to disrupt an auditor's ability to do their job and make management fearful of being open with the auditor.
38. PwC had a dedicated level of resource within its firm that looked at these sorts of issues such as greater engagement with investors. This included the time of one of its UK executive board members who spent 40 to 50 per cent of his time on these sorts of issues. It was necessary to spend so much resource in engaging with shareholders, to understand their needs, because it was shareholders that employed it. It believed its competitors were expending similar resource. PwC's regulators were also spending an increasing amount of time to understand the perspective of investors and this increased the need for PwC to engage with investors so that it could understand the imperatives coming from its regulators.
39. If PwC, as auditor, was asked a question in an open general meeting, then, subject to obtaining the Chairman of the meeting's permission, it would answer it.

Audit Committees and Audit Committee Chairs

40. PwC considered that the vast majority of ACCs were doing their job well. A small minority could probably be a little more probing or should try and spend more time in the role. A number of people who had gone into non-executive ACC roles had incentives to perform well to grow their non-executive director career. Most companies reviewed the effectiveness of their Audit Committees every year where all the Audit Committee members were surveyed confidentially by the Company Secretary with a summary being presented to the Company Chairman. PwC thought it inevitable that in a population of 350 companies, some Audit Committees and Audit Committee Chairs would be better than others.
41. Audit Committees had full visibility at the beginning of the audit plan and an opportunity to probe areas such as the key risks and judgements, and the approach for the audit. Audit Committees would then be updated on whether the audit was progressing as planned and see the depth of analysis, thinking and judgement taking place.

The Audit Committee would also have the opportunity to glean further information from a variety of other sources including management and internal audit.

42. On the basis that companies wanted to perform well, companies would want to communicate the way they were performing in a relevant and reliable way to shareholders, and so the incentives of an investor wanting relevant and reliable information were aligned with that of a company and so of the Audit Committee.
43. On the competence of Audit Committees and ACCs, ACCs were voted in every year, and more ACCs were being asked to talk at AGMs. These served as checks and as an incentive on ACCs to perform well. The demands on ACCs had gone up dramatically over the last ten years and, as a result, Audit Committees had raised the bar significantly in terms of how they performed. Some companies had a policy of requiring non-executives to have share ownership within the company to align themselves with investors. There was an element of professional pride and integrity at stake for the ACC.