STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of response hearing with PricewaterhouseCoopers LLP held on 22 April 2013

Introduction

1. PricewaterhouseCoopers LLP (PwC) said that, given the Competition Commission's (CC's) reputation, there would be widespread interest, particularly in Europe and the USA, in the CC's conclusions in its investigation of the statutory audit market. Those conclusions could provide a template for other jurisdictions to build on. PwC was therefore concerned about the CC's criticism in the provisional findings of the statutory audit market and the relationship between shareholders and auditors. PwC noted that the CC's possible remedies did not seem to be liked or wanted by the regulator and, in PwC's view, risked damaging the audit and capital markets. PwC said that it was open-minded about change in the market and believed that the package of remedies it had put forward in its letter to the CC (dated 22 March 2013) demonstrated that.

Provisional findings—opening comments

2. PwC did not accept that auditors put the demands of senior management over those of shareholders. Auditing standards were rules and regulations which had been developed over a number of years and operated effectively to guard against the theoretical risk that auditors competed to satisfy management rather than shareholder demand, with the Financial Reporting Council (FRC) and Audit Committees (ACs) at the centre of the governance model. A professional relationship with management was essential if auditors were to do their job effectively on behalf of shareholders and an auditor's reputation and licence would be at risk if he/she ignored the law that set out their duty to shareholders.

3. PwC agreed that the principal–agent construct created a risk, as highlighted in the academic literature, but the CC had made that risk a reality which was not what occurred in practice and the CC had disregarded the evidence that proved this risk was properly controlled in practice.

4. PwC objected to the CC's statement in the provisional findings that: 'There are significant, persistent and widespread concerns regarding the quality of audits delivered to the FTSE 350 companies identified by the [Audit Quality Review team]'.

5. PwC said that these words were not taken directly from an FRC or recent Audit Quality Review team (AQRT) report, the most recent of which actually highlighted a continued improvement in quality. To link a lack of independence with poor audit quality caused PwC serious concerns. PwC believed that the current audit market was defined by clear regulations enforced by effective regulators to guarantee high quality and an effective market.

6. PwC identified three underlying concerns with the provisional findings that made the CC's findings of adverse effects on competition (AECs) unsound:

   - Over-selective use of evidence: PwC believed that the CC had relied on weak evidence that supported its AECs while not sufficiently taking into account evidence supporting opposite conclusions.

- The evidence on outcomes was not indicative of a poorly-performing market: for outcomes to be indicative of a poorly-performing market, limited lapses were not sufficient; something more widespread was required.

- The failure to give weight to a material regulatory change: according to PwC, the CC had failed to give weight in the provisional findings to the recent changes to the UK Corporate Governance Code (Code) made by the FRC in September 2012 and consideration of this fundamental change only at the remedies stage of the inquiry was inadequate.

7. By way of example of the CC's selective use of evidence, PwC referred to the CC's analysis of pricing and profitability. PwC pointed out that the CC's analysis indicated a 19 per cent decrease in real fees per hour between 2006 and 2011, with average engagement profitability broadly steady over the same period. This demonstrated that cost reductions were not retained as profits, but were substantially passed on to clients which was a compelling indicator of a very competitive market. However, the CC had rejected this evidence of overall price reductions because the data did not control for factors such as the grade mix of engagement teams. In contrast, the CC did not deem the same unreliability of data to be fatal in reaching conclusions that were considered to be indicative of an uncompetitive market, in particular short-term price reductions following switching and variable engagement profitability.

8. PwC believed that if the CC could overcome its own reservations on the data, the strong evidence concerning price falls between 2006 and 2011 should also be taken into account. If the data concerning grade mix was a material impediment to data reliability, then the findings on price decreases post-switching, and the high profitability of certain engagements, which PwC in any case disputed, could not stand.

9. PwC could also not understand how the CC's conclusions on profitability could be considered robust when the provisional findings concluded that the underlying data was inadequate to reach an overall view on profitability. Similarly, PwC did not see how a conclusion that audit and non-audit service (NAS) profitability were similar could be used to determine that the audit market was not working well, when there was no suggestion that NAS markets were not competitive or were less risky than audit markets.

10. Another example was in relation to quality, where PwC believed that given the paucity of reliable evidence concerning profits and prices, much more weight than was usual in a market investigation was being placed on quality, independence and innovation which were difficult to measure. In particular, PwC objected to the weight given to the following: between 2007 and 2011, the AQRT had rated 10 of 149 FTSE 350 audits, just 6 per cent, as grade 3, that is, in need of significant improvement. According to PwC, the most that could be inferred from these figures was that there were occasional lapses in quality, which was a serious concern for those firms involved, but that this did not justify a conclusion that the audit market did not work well. The AQRT's sample also focused on the highest risk audits and so the average figure was likely to be lower than 6 per cent across the whole of the FTSE 350 as a result.

11. PwC disputed the weight the provisional findings had given to the AQRT's finding that the majority of audits were given a grade 2 score, which meant they were in need of some improvement. PwC believed this was inevitable as the Audit Quality Review (AQR) was conducted post-audit and reviewed a service (ie audit) that required judgement to be exercised. The bar for these reviews was raised annually and even a grade 1 score was not regarded as a perfect score: it was impossible to get a perfect score.

12. In contrast to the reliance on this evidence, no weight whatsoever was given to the finding from the CC's survey of Audit Committee Chairs (ACCs) that almost 100 per cent of ACCs, whom the CC acknowledged to be well-qualified, experienced individuals, professed themselves either very or quite confident in their ability to assess audit quality, and said that the principal reason to switch audit firms was to improve audit quality. PwC believed that the conclusion that there were widespread quality concerns was also at odds with the assertion in the final paragraph (13.9) of the provisional findings that 'Most companies and most auditors perform their functions diligently and effectively most of the time'.

13. Further, PwC believed that the provisional findings had failed to recognize that recent changes made by the FRC to the Code concerning ten-year tendering were having an effect on the audit market and tendering in particular.

14. The provisional findings had concluded that the competitive process worked well when there was a tender (paragraph 9.256) and provisionally concluded that the process did not work as well absent a tender and, because of the opportunity costs of tendering or switching, tenders were relatively infrequent (paragraph 9.258). On that basis, should there be a change in the market that made tenders more frequent, those concerns would be quite significantly diminished.

15. According to PwC, there had been such a change: the September 2012 changes to the Code would be likely to lead to an annual increase from eight to ten FTSE 350 tenders a year to around 35. PwC believed that the provisional findings were predicated on the prior status of the market of infrequent tendering. There was no recognition that the Code changes had transformed the landscape or analysis as to whether they had done so.

16. PwC cited paragraph 38 of the CC's guidelines[1] and the CC's Movies on pay-TV investigation and emphasized that the new tendering regime was a long-term regulatory change and that in failing to consider the changes to the Code, the CC had not considered all relevant material in reaching its decision and gone against its own guidelines in deciding whether there were features of the market that gave rise to an AEC.

17. PwC further noted that the FRC had also been positive about the Code changes in its submission of 18 March 2013: 'The new measure appears to be working well and generating pressure to consider switching.'

18. Therefore, according to PwC, the Code changes should have been taken into account in deciding whether there was an AEC in the first place, particularly given the finely balanced nature of the evidence in this inquiry.

19. In summary, PwC believed that the CC's conclusions suffered from an insufficiency of reasoning and were based on the selective and inconsistent use of evidence.

Remedies—opening comments

20. PwC believed that there was a big difference between remedies that empowered shareholders and the AC as their representative and remedies such as mandatory rotation and shorter-period mandatory tendering that would have the opposite effect and disenfranchise shareholders.

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[1] 'Although there may be circumstances in which analysis can be conducted only on the basis of the current state of the market, the CC always considers how a market may evolve.'

21. Mandatory rotation removed the shareholder's right to choose the best provider of the service and disempowered the owners of a business. To disregard the FRC's considered view that ten years was the correct, maximum period for tendering and introduce more frequent mandatory tendering would remove an important aspect of a shareholder's ability to decide when and when not to go to tender. This, combined with the CC's observations around the lack of independence and the proposition of mandatory tendering as a remedy, was not supported by the evidence and went directly against the views of the market regulator.

22. Positive remedial action to reinforce transparency and underpin competition would see the strengthening of the accountability of the auditor to shareholders through the AC, and the improvement of activities of all ACs to the standard of the best today. Improving AC effectiveness and enhancing communications between shareholder, auditor and AC was also critical. The changes currently under way with regard to the auditor's report would bring a greater level of insight directly to shareholders and would constitute probably the only significant change over the past 50 years to the binary audit report that investors say they value so much. Focusing on the examination and reporting of audit quality, including expanding the remit of the FRC, would, in PwC's view, better inform auditor appointment decisions.

23. If this package of remedies was taken together with the full impact of the FRC's changes to the Code concerning tendering, PwC believed that this was a proportionate response to the available evidence. This would bring greater transparency and competition without damaging audit quality or removing the incentive for ongoing innovation.

Provisional findings—members' follow-up questions

24. PwC acknowledged that it was very difficult to identify a threshold or percentage of grade 3 rated AQRT reports or restatements that would constitute a poorly functioning market. An appraisal of the trends of misstatements, as identified by Financial Reporting Review Panel reviews, was an activity that PwC had undertaken and was a possible measurement, as was the identification of the number of audit opinions that were withdrawn as a result of an AQR. PwC had worked to drive restatements down and had not withdrawn any audit reports.

25. PwC did not believe that, looking at the AQRT results and these measures, quality issues could be perceived as 'serious', 'persistent' or 'widespread'. Although any quality issue caused concern to PwC, it struggled to reconcile the CC's conclusions with the views expressed by the FRC, who assessed PwC's quality on an annual basis, by other regulators around the world and by ACCs, all of whom were very positive about PwC. [✂]. A level of judgement was involved when conducting an audit and it was not always possible to get this right. PwC supplemented the work of the external regulator with its own very substantial internal review process and published in its transparency report the results of this process.

26. PwC said that it was not possible to do multiple year deals regarding fees as an audit engagement was for only one year and had to be ratified annually by shareholders. When pricing a tender for an audit, the use of technology and shared-service centres were important considerations in determining whether the audit could be conducted for a fee lower than that of the incumbent. PwC would first calculate what it would cost it to conduct the audit. It would price on the expectation that it would have the audit for at least three years, even though it noted that it could not guarantee that the audit engagement would be in place the following year.

27. [✂] was an example of a company whose investment in SAP software would impact on the proposed fee, with a lower fee offered in the hope that the audit would over time become more efficient.

28. Companies were sophisticated negotiators, and in the case of [✂] use of SAP software, the client knew that the cost of the audit would reduce in three years' time and used this as a bargaining tool in reducing the audit fee.

29. PwC noted that, on occasion, where the assumptions on which it had tendered were materially incorrect, it might reopen discussions on price in year two; for example, if a new issue had been identified or a particular audit area was taking more time than initially envisaged. PwC said that if they were happy with audit quality, ACs were typically quite receptive to such discussions.

30. Companies had become more effective at bargaining and many FTSE companies used procurement specialists to negotiate, whereas previously this would have been done by the AC.

31. PwC had had tenders triggered by negative AQRT reports and lost clients as a result. [✂] was one example of this and had decided to go through a tender process due to the issues raised by the AQRT. Whether the client was retained or lost was dependent on the nature of the issues. There was always a difficult conversation to be had as the client was concerned about its reputation and the AC would want to know what would be done to resolve the issues raised by the AQRT. In the AQRT's most recent report on PwC, which was in draft, there was overt recognition by the AQRT of improvement with regard to professional scepticism and with PwC's efforts to deal with that over the last 12 months.

Mandatory tendering

32. PwC said that 97 per cent of FTSE 350 companies opted to comply with the requirements of the Code and, based on the conversations it was having with companies, expected that 'explain' would be a very rare event.

33. For example, the 'comply or explain' arrangements regarding the rotation of audit engagement partners (AEPs) allowed audit firms to extend the tenure of the AEP beyond five years at the request of the AC, and this would typically be reviewed by the FRC after the event. PwC signed around 6,000 audit reports per year. It was aware of a small number of instances where it had extended the tenure of an AEP by one year on a 'comply or explain' basis and these cases had been examined retrospectively by the regulator. Every instance of 'explain' received full transparency under the Code, which informed shareholders and enabled them to challenge the AC and board if they so desired.

34. PwC expected the level of 'explain' under the Code to decrease dramatically after an initial period of transition as the challenge for companies with the ten-year 'comply or explain' requirement was: when to begin that process? The CC's data showed that average audit firm tenure was 25 years, which implied that if the regime was implemented immediately, a number of companies would have to tender this year. This did not appear to be the case and the FRC had tacitly accepted that 'explain' was more likely to be linked to AEP rotation.

35. PwC believed the use of 'comply or explain' by companies in other contexts provided a reliable guide as to how it would be implemented in the case of audit firms. Companies were reluctant to 'explain' unless it was necessary, and the reputational

implications and reviews undertaken by organizations such as PIRC made it more likely that firms would comply.

36. PwC cited key boardroom changes or a large merger as instances where the tenure of an AEP may be extended, and considered that these reasons would be consistent with when companies might provide an explanation for not tendering at ten years. PwC had recently had a situation with [✂], where significant executive changes and the implication of a major new strategy occurred in tandem. The AEP was heavily involved in the accounting judgements and the review of the appropriate accounting systems and the company requested that he be retained for a further year. PwC acceded to the request as it believed it was in line with the spirit and form of the rules, [✂].

37. PwC expected that a second year of 'explain' would be unusual and, had it been sought, it would not have agreed to a second year of 'explain' in the case of [✂]. PwC would never totally rule out such an event in other cases, but it was very difficult to envisage a situation where this would occur, especially as key boardroom changes and large mergers only had effects over a small number of years. To delay the rotation of the AEP might also lead ACCs to question PwC's ability to provide an equally able team following the rotation, and to question whether PwC's audit partners were able to come in and take on the audit.

38. PwC did not see the need for a backstop to the 'comply or explain' mechanism in the context of audit tenders. It considered that the 'comply or explain' mechanism worked because if a company chose to explain, it was transparent to its shareholders why that was the case and shareholders would act if companies persistently provided explanations.

39. PwC did not see the 'comply or explain' mechanism as self-regulation and thought it had a significant effect in UK corporate governance. It was set by the Corporate Governance Code and not by the audit market. According to PwC, in jurisdictions where 'comply or explain' had not been such a common theme, the European Commission was now likely to use 'comply or explain' as its approach to corporate governance in order to give shareholders the flexibility that they had been requesting.

40. A requirement for organizations to 'comply or explain' in the context of a decision to tender, as opposed to mandating when a tender should take place, gave an organization the opportunity to do what was best for shareholders. It also allowed an explanation of its actions and allowed shareholders to have their say. PwC would be surprised if an AC saw value in choosing to explain why a tender was not being held for a sustained period.

41. PwC believed that companies chose to tender at the time best for them and the 'comply or explain' regime would facilitate this. Companies would work out for themselves whether they would see out the ten-year period before they tendered and the more cautious companies might run the process earlier in order to avoid potential difficulty at the end of the period.

42. PwC's preference for tendering every ten years was based on the fact that this was the period suggested by the FRC after extensive consultations. Key points were that it complemented the period of AEP rotation; and that the majority of investors also felt it was a sensible period. PwC believed that the ten-year 'comply or explain' approach was a very significant change that was already having an impact. It referred to its submission to the FRC where it had pointed out the desirability of linking tendering to the period of AEP rotation. One reason was that this was the point at which an even more rigorous review was undertaken by the AC and the

company because of the change in AEP; but it was also a point at which firms would increase their efforts on the basis that the AEP rotation was a recognized point of focus.

43. The preference for a ten-year, as opposed to a five-year, period was also based on PwC's belief that the more frequently firms had to compete for tenders, the harder they were to win (ie to displace the incumbent) and the greater the disruption caused. Independence was an important consideration in the run-up to a tender and PwC would look at the NAS it provided to a company and assess what was involved in becoming independent and how long that would take. There was also a one- or two-year disruption period as the company settled in with the new auditor, and tendering every five years would leave companies in a constant state of change. This might lead to audit firms not tendering as the disruption was too great, or to the tender process becoming an exercise in form over substance with no real company intent to change audit firm. Similarly, PwC also stated, with regard to seven years as a proposed tender period, that this would be inappropriate on the basis that, following AEP rotation at five years, to have a tender as soon as two years later for a potential change of auditor would be disruptive and leave companies in a constant state of change.

44. Companies typically indicated a level of dissatisfaction with their auditor and prepared the ground for a tender. PwC had a meaningful relationship with around 97 per cent of FTSE 100 companies and these large, sophisticated buyers alerted audit firms when dissatisfied to ensure that the firms they wanted to tender would take part in a tender. Both [✂] and [✂]had given two years' notice of their intent to tender. PwC was currently involved with a tender process with [✂] that, if successful, would see it take up the audit appointment in [✂]. PwC also hoped to win the audit of [✂], with which it was currently working [✂]. A conversation had taken place with [✂] with regard to PwC's involvement with [✂], but this would have kept PwC from participating in a tender for its audit for two years. On this basis, it was PwC's view that the more frequently audit tendering was required, the more difficult it would be for audit firms to keep themselves 'independent', or alternatively, firms would choose not to participate in the tender.

45. PwC agreed that there had been signs of increased tendering following the Code changes but recognized that those companies that had recently tendered had done so for a specific reason. Following the appointment [✂], though complying with the regulations, [✂] AC felt it would be better to tender [✂]. The tender at [✂] had been on the table for quite a while and the change at [✂] was a result of what happened at [✂].[✂], which had had the same auditor for a long period, took a very deliberate decision to tender in anticipation of the Code changes.

46. From PwC's point of view, as a consequence of the FRC's changes to the Code, there had been a sea change in the relationship between companies and auditors of long standing. PwC expected, based on recent conversations with ACCs, that the decision to go to tender was under consideration by the vast majority of ACCs and that it did not seem likely that companies would seek to 'explain' for a sustained period. PwC thought it would be useful for the CC to speak with ACCs and obtain their views on the ten-year period for tendering and what their intention was as regarded tendering the audit.

47. PwC also noted that a number of firms had instigated a five-year review of their auditor. When the AEP was rotated, firms would often see three new partners as part of the process and the audit plan would also be presented, which was regarded as something that could trigger a tender. Though not codified, this more formal approach was more common at the 'best practice' end of the market. The FRC had

also explored how the ten-year rotation was applied with regard to ACCs, investors and audit firms and concluded that it appeared to work well and generated pressure to consider switching.

48. A number of respondents to the FRC consultation did express views on competition when considering the ten-year period. PwC felt that the FRC's changes to the Code would increase the level of tendering and lead to increased competition.

49. PwC was not against the principle of open-book tendering, but had concerns with how it might work in practice. The provision of a consistent data set and allowing bidders to see the key judgements and risks identified was a sensible approach. But PwC designed its audit to be different and believed it had unique intellectual property in how it executed its audit and would want this excluded from an open-book process. PwC said that it invested heavily in changing the way it carried out audits to make them more competitive and so it was concerned that innovation could be compromised by an open-book process. PwC believed that, with appropriate consultation, it would be easy to design an open-book process but that it would be necessary to ensure that the incentive to innovate and the incentive to compete was not removed. PwC also highlighted that companies would have concerns as to the extent of confidential information that bidding audit firms would have access to in open-book tenders.

50. At present, PwC believed that the information it was required to pass to the incoming auditor on losing a client was sufficient to protect its intellectual property and encourage innovation. The incoming auditor received sufficient information, which helped reduce the risk of issues arising post-switch.

51. PwC said that the resources it devoted to a tender were to a large degree determined by how a company wished to run the tender process. PwC favoured a process that was robust and driven to make the right choice rather than one driven by cost. The firm's decision to bid also took in to account the likelihood of a successful bid. PwC did not participate in the recent [✂] tender following discussions with the management team of [✂] about PwC's large share of the audit market in that particular sector. A bid for the audit of [✂] was not pursued as PwC was the auditor of [✂], which did not want PwC to audit [✂].

52. PwC said that for companies of a certain complexity, there was a minimum level of resources that would be allocated to win a tender. Data analysis and a risk appraisal of the company would be undertaken and further resources were determined by the way in which the AC would want to run the process. For example, [✂] conducted 40 interviews over the course of eight weeks. [✂] was running the tender process over a period of four months, with audit firms expected to travel to locations across the globe. Such periods would involve a lot of preparation to win the bid and it was quite difficult to estimate how much this would cost.

53. PwC would go beyond a tender specification if that would improve its chance of success, though the decision to do so would be considered carefully because not all companies appreciated PwC doing this. For example, PwC had recently been through a re-proposal for [✂]. The tender specification precisely set out a list of meetings and attendees and made it clear that this schedule was not open to change. Other companies did not have such a defined format and PwC would attempt to spend as much time as was possible with the ACC and members of the AC as they were the critical decision-makers.

54. Factors in the decision to bid for a tender would include a risk assessment of the company, the way it operated and the propensity of a company to re-tender on a

regular basis. For example, PwC was the incumbent auditor at [✂], which had operated on a [✂]-year tender cycle and this would have been taken into account when PwC decided to bid. [✂] was also an audit client of PwC and each year a large amount of time was devoted to an assessment of whether PwC wished to continue as its auditor. A significant exercise of judgement would go into such an analysis.

55. Once engaged in a tender process, the feasibility of conducting the audit would become clearer. One of PwC's current tenders was posing very significant challenges for PwC in ensuring its independence. [✂]. In a scenario such as this, PwC would discover as it went through the tender process whether it could overcome such issues. PwC could not think of an example where it had gone through a thorough analysis of whether or not to bid, and then concluded that it should not continue with the tender.

56. PwC believed that in a number of areas the regulations around auditors' personal independence had responded to a perceived problem but, according to PwC, some aspects of regulation had arguably gone beyond a reasonable level, such that they were too focused on trivial aspects. However, some areas of personal independence such as holding shares and having business relationships with an audit client were sacrosanct.

57. PwC said that in terms of managing the tender process, it was becoming more efficient at putting together first draft proposal documents, but was also facing increased expectations from companies as to how it would differentiate its audit from that of other firms, as competition for audits increased.

Mandatory rotation

58. PwC believed that the CC did not have the evidence to support a move to mandatory rotation; that it would be wholly inappropriate on that basis; that it would be anti-competitive and would deny a company and its shareholders the option to choose the best audit provider for that organization; and that it would be a disproportionate move given the weak evidence on market outcomes.

59. PwC did not believe there was a potential conflict regarding independence when rotating the AEP, given the firms' practice of ensuring seamless transitions between outgoing and incoming AEPs. The AEP and auditors in general would approach each engagement with an open mind and not on the assumption that something wrong had been done. Rather, auditors sought to determine whether the correct decisions had been taken.

60. PwC highlighted the fact that, under the current regulatory environment, audit firms were not allowed to indemnify AEPs. AEPs were personally licensed and could be sued as an individual, with unlimited liability, if they were to get something wrong on the engagement.

61. Before a new AEP commenced an engagement, PwC had in place a number of safeguards to ensure that it was not solely reliant on one individual's (ie the former partner's) judgement. PwC had 'Quality Review Partners', who did not meet the client and had an overview of the audit. PwC also undertook 'hot reviews' of a FTSE 350 company's financial statements that allowed an assessment of their corporate reporting so the new partner was in fact the third set of independent eyes in an audit. In addition, in response to the AQRT findings and pressure from ACs, PwC had introduced [✂].

62. PwC believed that there were risks associated with tenders, as well as AEP rotation, with regard to an auditor's judgements. It was important to be open with a client and independently challenge decisions in a robust way.

63. The focus on tenure by investors was very high and was making companies feel uncomfortable. PwC believed that under a ten-year tender regime, tenure would be an important consideration for companies which would in turn make it more difficult for the incumbent auditor to be reappointed.

AQRT reviews

64. PwC believed that cost and resources would have to be considered if the scope of AQRT reviews was to be increased. As an alternative to expanding the current review process, PwC reported the results of both its own internal quality testing and its AQRT results in its published transparency report and, if other firms were to disclose the same information in their transparency reports, this could enable companies to better compare audit firms.

65. PwC believed that the regulator had become increasingly effective at examining the overarching system of controls operated by audit firms, rather than focusing on individual engagements. It would then sample test the individual engagements on a risk-weighted basis, focusing on those audits where the risks were highest. PwC found this approach by the AQRT useful in highlighting to it systemic risk.

66. The regulator increasingly provided a narrative on market events. This was useful in an environment where the challenge of measuring quality was hampered by external factors and the market itself was very dynamic. In June, July and August of 2007, there were £40 billion worth of new securitized loans created each month. In September 2007 this had reduced to nearly zero. This had caused PwC to re-evaluate to a very high degree how it looked at going-concern statements and impairments.

67. The tone of an AQRT report was very important to PwC and it was very sensitive to what those reports said. Comments such as 'systemic' or 'specific' had an impact. To address quality issues, the regulator had started, or would shortly start, contacting ACCs ahead of a review to build an understanding of what the auditor had focused on or should focus on. PwC did not believe the AQRT reviews provided a definitive indicator of audit quality, but this type of change confirmed that the regulator was seeking to improve its review systems and their reports were undoubtedly having an effect on the market. PwC stated that it monitored the trends and tried to ensure that it was (and was seen to be) continually improving.

68. PwC believed that the FRC should continue with its overall supervision of audits, but to also provide information that would allow purchasers to make an informed decision. Resources and timing would be factors if the changes proposed by the CC were to be implemented, particularly if the level of staffing at the FRC had to be increased.

69. PwC also felt that the transparency reports produced by audit firms provided audit purchasers with data on quality. The reports from various firms were of variable quality, and they did not have the profile PwC would have liked, including with investors. PwC was working hard to change this and encouraged its teams to use the PwC transparency report with existing and potential clients including as part of the tender process.

70. The transparency reports were required, in part, under European legislation, but the requirement was for a narrow set of data. PwC had taken the decision some years ago to inform the market better about some of its processes and measures around quality. The report was well received by those who used it, but it was not as widely used as it could or should be. PwC believed that giving the report more profile alongside the external regulatory reviews would provide another perspective of quality and assist purchasers. The FRC's Audit Firm Governance Code was also instrumental in improving the quality of transparency reports in the UK.

71. The content of the transparency reports varied by firm and was inconsistent, with some firms' reports including internal quality review scores, some talking about their public interest body, and varying levels of detail on firms' networks.

72. PwC had not formed a view on whether the FRC had a role to play in the promotion of competition but believed that the FRC should focus primarily on audit quality. PwC had provided a submission to the European Commission reinforcing this point.

73. PwC said that it had limited contact with the US Public Company Accounting Oversight Board (PCAOB), meeting with it perhaps once every three years. The PCAOB tended to be more legalistic in its approach, possibly reflecting its staff who predominantly had a legal rather than audit background. The PCAOB recognized the expertise of the FRC and both were very much focused on audit quality. Over the past few years both had succeeded in making audit firms undertake quite significant changes and the AQRT reports had demonstrated a trend of improved quality.

74. The PCAOB was interested in the UK model of transparency as it was constrained by what it could release into the public domain. One example of this was the naming of the audit partner on audit reports. A senior executive at the PCAOB thought this was a good idea, but there were concerns as to how US lawyers would react.

75. The International Forum of Independent Auditor Regulators (IFIAR), with which the PCAOB worked extensively, now comprised more than 100 regulators from around the world. In addition, PwC noted that the Canadian Public Accountability Board had put forward to the CC the option of a comprehensive audit firm review every five years. This review would be at a more detailed and comprehensive level than the current practice and the market may have begun to consider the possibility of undertaking such reviews around AEP rotation.

Prohibition of Big-4-only clauses in loan documentation

76. PwC supported the prohibition of Big-4-only clauses in loan documentation and also the extension of the prohibition into any form of capital raising. PwC would also support an all-embracing prohibition, believing that it would send a strong message that such clauses were not acceptable.

Strengthened accountability of the external auditor to the Audit Committee

77. PwC said that reinforcing auditing standards, particularly those that dealt with transparency, and ensuring that there were environments where shareholders had the opportunity to question ACCs, were very positive developments.

78. Auditors had to work very closely with Finance Directors (FDs) to access the information that was needed and it was also important to get behind what the documents and data said. Relationships with ACCs and ACs involved an almost ongoing week-to-week involvement. The level of contact was built through phone calls at key points

of the year and meetings with ACCs in advance of AC meetings, which typically met four to six times a year. This type of contact was not only confined to companies at the top of the FTSE 100 and had extended across the FTSE 350.

79. From PwC's experience, ACs of companies towards the bottom of the FTSE 350 were aware of all material issues, were well briefed and actively went through the audit plan. But not all ACs performed at the level of those at the top of the FTSE 100 and encouragement for them to do so would be worthwhile.

80. Company boards were required to perform an effectiveness review every three years, facilitated by an external party, on a 'comply or explain' basis. There was no reason why this could not be extended to ACs, enabling new ACCs to be aware of best practice and bring a continuity of best practice across ACs.

81. Transparency was an important component in the process of improvement. The reporting in AC reports of major issues which they had debated with the company's auditors would help form a view on the effectiveness of the AC, as would more openness on how ACs oversaw the governance of the audit and the AC's interaction with the AEP and audit firm.

82. The International Auditing and Assurance Standards Board (IAASB) would also be consulting on improvements to ISA 260, which was the standard that mandated what auditors had to speak with the AC about. The aim was to tighten the rules on the content provided by audit firms to ACs.

Enhanced shareholder–auditor engagement

83. PwC said that shareholders became involved today where they saw there was a very significant issue but that there was a need for realization that shareholder engagement in companies' affairs and a shareholder's focus on individual companies was driven by their own risk evaluation. Achieving full stakeholder engagement was difficult for companies to achieve and a large part of improving stakeholder engagement was driven by the desire to try to get shareholders focused. Annual General Meetings (AGMs) provided a good environment for shareholders to voice their opinions and raise issues and reduced excuses for not engaging.

84. To encourage shareholder engagement, PwC saw the AC report in the accounts as an essential tool to improve transparency to shareholders. Increased information being provided to shareholders through an improved across-the-board performance of ACs would give the shareholders the opportunity to intervene on specific issues when they felt it was appropriate. It was important to note that the ACC was almost always at the AGM and could answer questions and the auditor was always in attendance.

85. Executive remuneration was one example of an issue that used to pass at AGMs without much controversy, but which was now very much on the agenda for shareholders. In the case of [✂], PwC [✂] existed among shareholders, but both had been unaware of its extent.

86. Engagement with investor groups such as the Association of British Insurers was a recent development in governance. Recent conversations saw PwC questioned by investor representatives [✂]. The AGM provided the 'nuclear' option for shareholders where they had the opportunity to vote down motions. Informal channels of communication between shareholders, ACs and ACCs existed, but relied on transparency of information.

87. If shareholders were unhappy following the reappointment of an auditor without a tender, they could vote against the motion to reappoint. If the vote went against the reappointment, the company would automatically have to go out to tender. PwC agreed that a shareholder who wanted a company to hold a tender could submit a formal motion to effect this under the existing AGM regime.

88. Some companies put contingencies in place where it was judged inappropriate to reappoint the existing auditor. As an example, there was a situation that involved [✂], where PwC was on standby in case its auditor, [✂], could not be reappointed.

89. PwC did not support the use of special resolutions for reappointment of firms after a specific tenure, which required 75 per cent of a vote, as a potential remedy. The AC was the representative of all shareholders and such a move would allow the minority to drive the majority. The use of special resolutions was intended to protect the minority from substantial change of direction rather than attack the majority. PwC had never witnessed shareholders vote against the judgement of non-executive directors and such an occurrence would amount to a vote of no confidence.

90. PwC said that allowing shareholders to vote on a choice of two audit firms, following a tender, with the AC giving its view on its preferred choice, would undermine the importance of the AC as the representative of the shareholder. The shareholders' view of the two firms would be based on a superficial review of the information that had been made available to the board and such a remedy would detract from the power of the AC, which would have gone through all the available information, to make a specific recommendation to shareholders.

Extended reporting requirements

91. PwC supported extended reporting requirements and believed this should be done through the IAASB, which would publish an exposure draft in June this year addressing this particular issue. If the IAASB had not been looking at the issue, there would have been a stronger case for the FRC to work on this. It would not be a surprise if the IAASB's exposure draft was delayed due to the number of bodies that had to agree it. The Accounting Standards Board had also put formal proposals forward for consultation.

92. Though supportive of extended reporting, PwC recognized that there was a risk of the reporting becoming boiler plated, particularly in view of the legalistic approach adopted by US regulators, with the end-product not being meaningful or useful for shareholders.

Closing remarks

93. PwC reiterated its serious concerns about the provisional findings and some of the remedies that the provisional findings were leading the CC towards. In particular, PwC believed that the evidence on independence and quality did not support the proposal of mandatory rotation.

94. Driving quality and transparency was important in achieving the right result and getting these right would also drive competition. In considering remedies, the CC should be absolutely clear about the importance of the AC and ensure that shareholders knew of the vital work the AC undertook on their behalf. Communication between ACs and shareholders was an important facet of this.

95. The CC should focus in on quality when considering possible remedies, and look particularly at those who reviewed quality and how they executed their remit, because remedies focused on these areas would help drive quality and transparency. Transparency reports were underused and if those reports were improved and used more frequently, they would be a useful tool for shareholders and would provide them with the information they needed on quality.

96. PwC strongly disagreed with the comparator used by the CC in the provisional findings that 'auditors behaved more like corporate advisers than investigators' as auditors were neither corporate advisers nor investigators. PwC emphasized that it went in to every audit with an open mind and that whilst auditors could, on occasion, move in to investigatory mode, the auditor's focus was on complying with auditing standards and ensuring that relationships adhered to ethical and auditing standards. Auditors were obliged to adopt a sufficient level of scepticism during engagements but focused on producing a true and fair opinion.

97. PwC said in relation to the remedies that the CC were not currently minded to pursue, which it was strongly against, PwC would want to engage further with the CC if any of those remedies were to be pursued.