15 November 2012

Non-confidential version

PwC Combined Response to the CC's "Profitability – Part 1"& "Profitability – Part 2" Working Papers

1. This paper sets out our combined initial views on:

   (a) The *Profitability – part 1* working paper published by the Competition Commission (**CC**) on 3 October 2012 (**WP1**); and

   (b) The *Profitability – part 2* working paper published by the CC on 22 October 2012 (**WP2**).

2. WP1 and WP2 indicate that the CC has so far found no evidence of excessive profits in the FTSE 350 audit market.

3. We agree with the CC that the significant level of intangible assets employed in this market makes a return on capital employed (RoCE) analysis inappropriate.[1]

4. We have provided the CC with rigorous and detailed analysis demonstrating that a return on sales (RoS) approach is the best methodology for assessing profitability in this market and that such an approach demonstrates that profits are at a competitive level.[2] Our analysis received independent academic endorsement from Professor Ian Cooper of the London Business School.

5. The CC has chosen not to undertake a RoS analysis. We consider that such an analysis is perfectly feasible, as our own analysis demonstrates, and therefore do not agree with the CC's reservations in this regard. The CC's specific reservations with RoS,[3] and our brief response to these reservations, are:

   (a) **Difficulties in determining a robust audit cost allocation**: In our Profitability Submission, we carried out extremely detailed cost allocations that are robust. In previous competition investigations the CC has undertaken, what we consider to be more complex product-level cost allocations within multi-product firms, and drawn conclusions on profitability. There is no reason such analysis cannot be undertaken here.

   (b) **Observed differences in net assurance margins across the four largest audit firms**: There are a number of reasons beyond cost allocation that may cause net margins for assurance practices to vary across the four largest audit firms – for example, there may be significant differences in, (i) business models; (ii) commercial priorities; and (iii) differences in the mix of businesses that fall within the firms' assurance divisions. (We also note that operating margins for mid-tier audit firms – who operate largely outside the FTSE 350 market – are higher than for the largest audit firms[4]).

   (c) **Difficulties in benchmarking partner salaries**: We carried out robust partner salary benchmarking using an approach which is employed by a number of private sector and public sector organisations and which was endorsed by Dr. Jonathan Trevor of the Cambridge Judge Business School (a leading academic in this field).

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1 WP1, paragraph 58.
2 *Observations on the assessment of audit profitability*, PwC, 31 July 2012, (**our Profitability Submission**).
3 WP1, paragraph 85.
4 See figure presented in Annex 2.

(d) **The sensitivity of the RoS measure to changes in assumptions**: All measures of profitability are inherently sensitive to underlying assumptions, but this has not prevented the CC from estimating – and concluding on – profitability in other investigations. Even when key assumptions are flexed using reasonable sensitivities, there is no evidence to suggest that our audit business generates excess profits.

6. We do not accept that our audit business is low risk. Our audit business, unlike the majority of our non-audit businesses and most other professional services, faces substantial reputational risk for the firm and for individual partners and unlimited financial liability in relation to audit client litigation. The long-term nature of audit client relationships and our limited ability to adjust the minimum scope of audit engagements in the face of downward fee pressure also increase the risk of our audit business. Compared to shareholders of public companies, partners (as business owners) face relatively high risk, as they are less well diversified in their investments, and both the salary and return on capital elements of their remuneration are at risk.

7. We note that the CC has indicated that it is considering a measure of profitability based on total partner remuneration, which is derived from the profits of all the firm's activities (of which audit is but one).[5] We have explained to the CC why such an approach fails to provide an effective measure of profitability in the audit market and why the analysis that the CC has carried out is economically meaningless and highly misleading.[6] It would be wholly inappropriate for the CC to decline to perform a RoS analysis while choosing to adopt a patently inferior and inaccurate methodology.

8. As long as the CC does not come to a decision based on a finding or assumption that profits are or may be above the competitive level, we are content not to pursue this matter further.

9. In the annex to this document we provide our responses to certain specific points identified in the working papers.

PricewaterhouseCoopers LLP
15 November 2012

[5] WP2, paragraph 5 to 21.
[6] *Response to CC's Profitability Follow-up Questions*, 8 November 2012.

Annex 1: Detailed paragraph-specific comments

A1. We set out below our comments in response to a number of further specific assertions made in WP1 and WP2.

Reasons for difference in PwC's partner and director scale rates and "salaries" (paragraph 44 of WP1)

A2. The explanation provided for the relative difference in partner/director scale rates and "salary" differentials is not consistent with what we have submitted on this issue.[7] The reasons for low scale rates (in comparison to "salary") for partners relative to directors are:

(a) Firstly, partners have primary responsibility in the important tasks of generating work for the firm and acting as leaders of the business. The value of partners to the firm, and hence the reward they receive, is strongly linked to their roles in these areas which distinguish them from other employees. It would be problematic to explain to clients that they should pay higher fees for using partners based on higher rewards associated with these activities and skills of partners, as they would not be directly applied in the hours charged to a particular client engagement.

(b) Secondly, partners have an important role in leading, overseeing and quality controlling our client work. Scale rates at the level set for partners ensure clients are not hostile to partner involvement and facilitate our ensuring - through adequate partner involvement - the very highest quality of our work for our clients. Similarly, due to these relatively low rates, our staff (who are in part assessed on the economic performance of assignments they work on) are not dis-incentivised from seeking partner input.

Audit's position within the PwC firm structure (paragraphs 11 and 20 of WP1)

A3. At paragraph 11 of WP1, the CC presents a diagram detailing where the profits of an audit engagement are recognised within the organisational structure of audit firms. Paragraph 20 of WP1 further states that "*Audit sits as a service within a wider Assurance business unit.*" Although revenue and costs of audit and audit-related services are primarily recorded within the Assurance line of service, it is important to appreciate that this does not reflect how audit and audit-related services are delivered to clients.

A4. As described repeatedly in our previous submissions[8], PwC does not have a standalone "audit business". While nearly all audit engagement partners and a large number of dedicated audit specialists sit within the Assurance line of service, audit services are provided using multi-disciplinary professionals from across all lines of services. The exact shape and composition of audit teams varies depending on the unique needs of each client, ensuring that a high-quality, bespoke product is delivered.

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7 [✂]

8 See, for example, paragraph 2.1(d) of the PwC *Submission and response to Issues Statement*, 12 January 2012.

The risk profile of the audit business (paragraph 44 of WP2 and paragraph 62 of WP1)

A5. The CC questions the relative riskiness of the audit business in both WP1 and WP2. In WP2 the CC states that the risk profile of audit can be argued to be lower than that of consulting due to a less lumpy income stream, fairly stable costs, a high proportion of repeat business and significant long-term clients.[9]

A6. However, this statement does not properly consider the various aspects of risk that our business faces. In some respects audit is clearly *more* risky than consulting and other parts of our non-audit business - for example, with regard to our audit work we face unlimited liability that cannot be fully covered by insurance.[10] [✂].[11] By contrast, our non-audit work is frequently performed on terms whereby our liability is limited by contract.

A7. It is true that in recent years our efforts to ensure quality and our investment in risk management (reinforced by regulatory requirements) have reduced the number of claims against us that, if successful, could cause the firm to collapse and wipe out partners' capital and retained earnings. Nevertheless, we bear more costs of claims against the firm with respect to audit than to other services. As we showed in our Profitability Submission[12], around [✂]% of the value of past claims against PwC have been related to audit services, despite audit comprising less than one quarter of our revenue.

A8. Furthermore, although a lot of our audit engagements are repeat business, each year's work is based on an annually renegotiated contract. As part of this renegotiation, both price and scope are closely reviewed by our clients and therefore subject to substantial volatility.

A9. In WP1, the CC indicates that, were it to adopt a cost of capital to assess profitability, it would need to consider more carefully the estimate of the equity beta used in our Capital Asset Pricing Model (CAPM) based cost of equity (0.8 on a five-year average basis). The stated reason for this is given that "*audit is a relatively non-cyclical business and therefore may be considered to have low systematic risk in comparison with other activities undertaken by professional services firms and consultancies.*"[13]

A10. Audit is not significantly less systematically risky than indicated by an equity beta of 0.8, which is already below the average of 1.0. It is true that there is a fixed annual *quantity* of statutory audit services demanded by companies within the reference market. However, there are a number of reasons that cause the *prices* of audit services to respond strongly to systematic risk factors. These reasons include:

(a) During economic downturns, buyers of audit services face strong downward pressure on their budgets. These pressures impact directly on the willingness to pay for any discretionary part of audit and audit-related services.

(b) PwC is committed to delivering audits of only the highest quality. Regulation is also designed to ensure the quality of audits. This means that when faced with downward fee

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9 WP2, paragraph 44.
10 [✂]
11 [✂] See Q43 of our MFQ response for further detail.
12 Profitability Submission, paragraph A4.18(c).
13 WP1, paragraph 62.

pressure from clients, we have limited scope in the short-term to adjust the resources committed to a particular audit engagement. Falling fees thus translate not only to falling total revenue, but also falling revenue per hour of client-facing staff time and, resultantly, falling profitability.

(c) The nature of our relationship with a client we audit is typically structured on a much longer-term basis than that for a typical non-audit client. Non-audit engagements are more ad hoc and are often one-off in nature. Because of the longer-term audit relationship, companies are able to place proportionately more pressure on audit fees than would be possible in a non-audit engagement. We are more likely to decline a non-audit engagement where our client places significant downward pressure on fees than is the case for an equivalent audit engagement. This is because it is not possible to decline to perform an audit during a recession when fee rates are under pressure, and then simply re-engage when the fee rates recover.

A11. As described in our Profitability Submission[14], the CAPM framework adopted for estimating the cost of equity only compensates investors for systematic risks and not specific risks. However, for the reasons set out in our Profitability Submission, PwC partners may be exposed to specific as well as systematic risk and so, if anything, may require a higher rate of return than indicated by a CAPM-based cost of equity.

A12. In particular, we pointed out in our Profitability Submission[15] that PwC partners:

(a) may not typically be fully diversified with respect to their equity investment in PwC, which has not been taken into account in calculating the cost of equity;

(b) have their entire reward at risk, not just the element relating to return on capital i.e. the part of reward which is "partner salary", including notional base pay, is at risk depending on business performance; and

(c) face a higher risk profile with respect to audit work, where PwC faces unlimited liability that cannot be fully covered by insurance (see paragraph A6 above).[16]

A13. The CC acknowledges that it may be appropriate to include an upwards adjustment to the cost of capital when it comments that there is merit in the view that "*there should be an uplift in the cost of capital assessment to take account of the fact that investors in audit firms are not diversified.*"[17]

A14. Although we have not looked at this issue in any detail, the likely magnitude of any uplift would greatly exceed any possible downwards adjustment to the equity beta in a CAPM-based cost of equity estimate. For example, in WP1 the CC cites Oxera's 2007[18] report to the European

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14 Profitability Submission, paragraph A7.13.

15 Ibid.

16 This is a specific risk of a large company audit practice which should be reflected in audit prices, but is not included as a cost in either our return on equity calculation or our audit cost base.

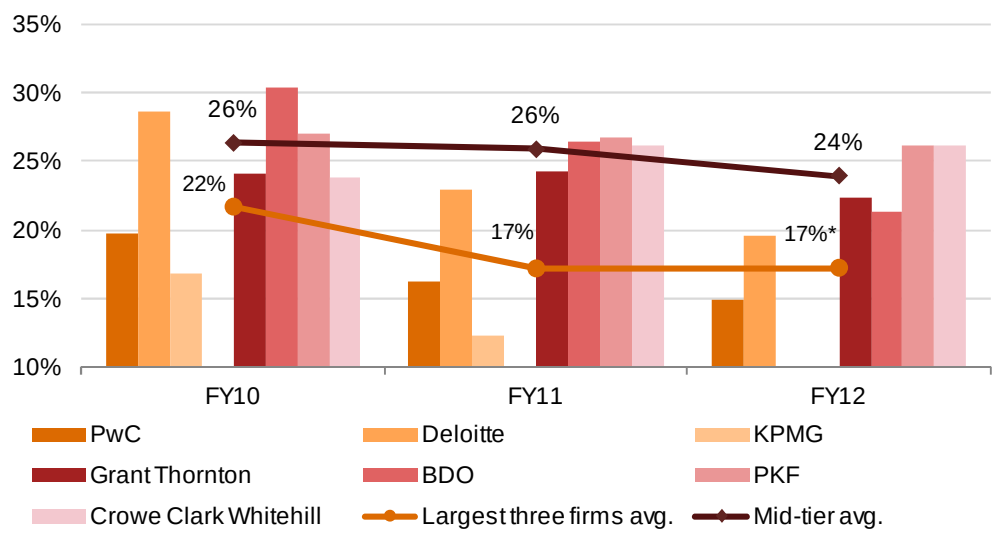
17 WP1, paragraph 63.

18 Oxera (2007), *Ownership rules of audit firms and their consequences for audit market concentration*, available online at http://ec.europa.eu/internal_market/auditing/docs/market/oxera_report_en.pdf.

Commission that suggested "*a range for the premium on the required rate of return of between 10 to 20 per cent*."[19]

[19] WP1, paragraph 59.

Annex 2: Audit operating margins



Source: Transparency Reports, PwC analysis.
Largest three firms average includes PwC, Deloitte & KPMG. Mid-tier average includes Grant Thornton, BDO, Crowe Clark Whitehill & PKF.
*FY12 largest three average based on PwC & Deloitte only. KPMG FY12 Transparency report not yet released. PwC FY11 margin based on restated figures reported in FY12 Transparency Report.