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PwC Response to the CC's Revised Issues Statement

- 1 This paper sets out our initial views on the Framework for Assessment and Revised Theories of Harm published by the Competition Commission (CC) on 10 August 2012 (the Revised Issues Statement or **RIS**). We will respond in detail to the issues that the CC has identified when the relevant working papers expanding on the framework are published.

Key characteristics of the supply of audit services¹

- 2 The CC has selected three “*fundamental characteristics...important to understanding the behaviour of customers and rivalry between auditors*”² - these are:
- (a) The nature of the audit product, notably the mandatory and bespoke nature of large company audits;
 - (b) The existence of information asymmetries and misalignment of objectives in supply of audit services; and
 - (c) The costs of audit supply, notably recognition that it may be inefficient for more than a small number of players to supply specialised sectors, and that smaller firms would have to make investments to replicate the competitive offering of the larger firms.
- 3 We agree that the first and third characteristics are relevant to the assessment of competition. However, we disagree with the second characteristic, and in particular the suggestion that any information asymmetries lead to a misalignment of objectives. We deal with this further below.
- 4 However, there is another much more fundamental characteristic which is not mentioned: the existence of at least four well-resourced and highly experienced suppliers offering services to a customer base that at any specific time consists of a limited number of the largest and most sophisticated companies in the country (if not worldwide), which are themselves experienced purchasers of goods and services.
- 5 This characteristic is important because it highlights: (i) the size and sophistication of the suppliers; (ii) the number of suppliers relative to a limited customer base; and (iii) the experience of the customers as purchasers of services and, in particular, the fact that this is a business-to-business market. Appreciation of this reality underpinning competition between suppliers of large audit services is fundamental to a competitive analysis of this market.

¹ We do not comment on the early paragraphs of the RIS prior to this section (paragraph 50 onwards) as these largely set out the background to the CC's understanding of the role of audit and the regulatory framework surrounding it.

² These characteristics are set out in paragraph 50 and expanded on in paragraphs 51-72 of the RIS.

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Summary of our response to the revised theories of harm

6 The RIS consists of only two theories of harm drawn from three of the original six theories of harm set out in the CC's initial Issues Statement. This suggests the CC (having considered the evidence) believes that the other three theories of harm set out in its initial Issues Statement were unsustainable. In our view, and based on our experience of competitive pressure in this market in practice, the two theories of harm in the RIS³ are also unsustainable.

7 In summary, our position in respect of the two revised theories of harm is as follows:

(a) The first theory of harm - **customer behaviour and market structure produce adverse outcomes** - is a subject we have covered in detail in previous submissions, notably within the "Four Pillars" as set out in our Submission and Response to the Issues Statement⁴ (our **Initial Submission**):

(i) **Large companies require a distinct audit service:** the four largest audit firms have evolved as a consequence of market demand for certain attributes to carry out the largest, most complex audits.

(ii) **There is fierce competition between large audit firms:** the large firms compete vigorously in relation to large company audits, constantly investing and innovating to improve their people, systems and methodologies, specialisations, and geographic coverage. They actively and aggressively target each other's clients.

(iii) **Large companies are effective purchasers:** the FTSE 350 are the largest listed companies in the UK and audit appointments are recommended to shareholders by experienced executives and audit committees (ACs) who understand audit quality and value, and who act in the interests of shareholders in securing competitive audit services tailored to their company's needs, using the threat to tender where appropriate. The competitive pressures to which these companies are themselves exposed makes it essential for them to secure a high quality and reasonably priced audit.

(iv) **Market outcomes are competitive:** the evidence shows companies are effective in securing a competitive audit price while also understanding and prioritising a high quality audit. The importance of retaining and winning individual audit clients and of audit firm reputation ensures that auditors continually strive to improve services and efficiency.

(b) The second theory of harm - **principal-agent issues** - relates in part to our Third Pillar (large companies are effective purchasers) and was addressed in detail in our Response

³ RIS, paragraphs 76-78 and 83

⁴ See our Submission and Response to the Issues Statement of 12 January 2012.

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to Certain Third Party Submissions⁵ (our **Response to Third Parties**), but we summarise our position on this below:

- (i) There is clearly potential for principal-agent issues to arise as between management and shareholders. This is precisely the reason we have audits and why ACs have been introduced and their role developed over time.
- (ii) There is also scope for information asymmetries as between either the auditor and shareholders or the AC and shareholders. The auditor will inevitably have a better knowledge of the business, its financial statements and its accounting issues than an often large, dispersed, diverse and changing body of shareholders. Shareholders will also inevitably lack knowledge of the detail of the audit that has been conducted. Similarly, an AC that is doing its job properly (as in our experience is the case for the vast majority of ACs in the reference market) will have a far better understanding of the work of the auditor and its quality than do shareholders.
- (iii) We explained in our Response to Third Parties⁶ how we have tried to improve the flow of information to shareholders, notably through our "*Building Public Trust*" initiative over the last decade. However, it is impossible to eliminate all information asymmetries not least because increasing the availability of information to certain shareholders may prejudice others (in breach of insider dealing rules).
- (iv) What is critical in this context is that such asymmetries do not in themselves give rise to principal-agent problems. As the RIS makes clear, such problems arise only "*where there is both a misalignment of objectives, and there are information asymmetries*"⁷ (emphasis added). Thus, for there to be principal-agent problems as described in the RIS it is necessary to establish (at the very least) that there is a misalignment of objectives between either auditors or ACs, on the one hand, and shareholders on the other.
- (v) The RIS suggests that auditors may respond "*to management demand rather than shareholder demand*"⁸ and that AC behaviour may not be properly aligned with the objectives of shareholders.⁹ The RIS contains no hard evidence to suggest that this is the case but rather states that in theory such a misalignment of objectives might exist.¹⁰ It also misses the point that it is important for auditors to develop an

⁵ See our Response to Certain Third Party Submissions dated 6 August 2012.

⁶ See paragraph 3.10 and Box 3 of our Response to Third Parties.

⁷ RIS, paragraph 11

⁸ RIS, paragraph 39

⁹ RIS, paragraph 42

¹⁰ We note that the Audit Quality Forum paper - *Agency theory and the role of the audit* - referred to in footnote 13 of the RIS is explicitly based on "*agency theory*" and contains no empirical evidence.

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effective working relationship with company management in order to fulfil their obligations to *shareholders* effectively and efficiently.

- (vi) Were either misalignment to exist, this would mean that auditors and/or ACs were failing to perform the principal tasks entrusted to them by law and regulation and, in the case of auditors, were acting contrary to their obligations and integrity as professionals. Acting in such a manner could cause potentially catastrophic harm to the reputation of the individual auditor and the audit firm. It would also seriously harm the reputation of the members of the AC charged with responsibility for oversight of the company auditors. Compelling evidence would be needed to demonstrate that this was the case - we are not aware of any such evidence.¹¹
- (vii) We are therefore concerned that the CC appears to assume that principal-agent problems exist in this market on the basis of an obvious asymmetry of information but an unfounded theoretical construct for misalignment of objectives, and that it then proposes to focus its analysis on the market consequences arising from such problems.¹² Before considering the consequences of a misalignment, the CC must first establish that such a misalignment actually exists.
- (viii) In the absence of such evidence, the second theory of harm falls, and the first is substantially undermined as it leaves informed purchasers acting in the interests of companies and auditors with the incentive to provide high quality and value for money services in fierce competition with each other. This latter scenario is what emerges from the evidence we have provided to the CC, and the results of the CC's survey and case studies.

8 We provide in the **Annex** a point-by-point high level response to these revised theories of harm, cross-referencing to where we have provided evidence supporting our position in previous submissions¹³, as well as drawing on the CC's survey¹⁴ and case studies where appropriate.

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¹¹ While there are individual examples of auditors and ACs being subject to criticism, these are isolated examples and do not demonstrate a systemic market wide misalignment of objectives. Occasional poor performance (in the context of highly challenging work requiring significant exercise of judgement) does not equate to acting deliberately against the interests of one's ultimate employers (i.e. the company's shareholders).

¹² Paragraph 70 of the RIS states that the CC will present evidence in the working papers of: "*the potential consequences of the interaction between these information asymmetries and the misalignment of objectives for competition in the supply of audit services to FTSE350 companies.*"

¹³ In particular in our Initial Submission, our response to the Market and Financial Questionnaire (our **MFQ Response**) dated 24 February 2012, and our Response to Third Parties.

¹⁴ The results of which - including the IFF Survey Presentation (the **CC Survey Presentation**) - were published on 26 July 2012).

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Annex

PwC response to the two revised theories of harm

We set out below our response to the two revised theories of harm by setting out our views (in outline only) against the framework in the RIS. As we have explained from the outset of this process, we consider that the evidence demonstrates that there is strong competition to provide a quality audit service in an efficient manner at a competitive price. We will continue to set out the evidence to support this position when responding to the more detailed working papers, as they are produced by the CC.

First revised theory of harm: Customer behaviour and market structure produce adverse outcomes

Demand side characteristics (paragraph 76, (a) to (e) of the RIS)

(a) Price does not drive tendering:

- (i) We operate in a market where we face continual pressure from companies to provide a high quality and good value service. The CC's survey and case studies¹⁵ show the value placed on quality, challenge and auditor independence, as well as audit efficiency.¹⁶ They also show regular scrutiny of audit fees and quality,¹⁷ while the empirical data shows that companies have been successful in driving down audit fees in recent years¹⁸, in most cases without recourse to audit tenders.
- (ii) As this shows, the price of the audit is a key consideration for all large companies who are keen to ensure that their audit represents good value for money as well as the required level of quality. If the price of an audit is not competitive or service quality is poor, large companies are prepared to tender to test the market if necessary.¹⁹
- (iii) The fact that each audit is tailored to the characteristics of a particular company does not mean that price comparisons are not possible.²⁰ Finance directors (FDs) and audit

¹⁵ For example, the Group Financial Controller of "Company G" in the case studies said that the "trigger points for a tender would be a slip in independence, skills or value for money." (paragraph 22 of the Company G case study)

¹⁶ See slides 26 and 28 of the CC Survey Presentation.

¹⁷ See slide 46 of the CC Survey Presentation. Similarly, the Group Financial Controller of "Company G" said that "it was the company's reputation and hence quality that mattered most" (paragraph 34 of the Company G case study).

¹⁸ See CC Engagement Data which shows average auditor hours per engagement have remained broadly static from 2006 to 2011, while average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms).

¹⁹ A "substantial increase in audit fee" is cited by 71% of FTSE 350 FDs and 80% of CFOs as likely to lead them to seriously considering changing their current statutory auditor (see slide 68 of the CC Survey Presentation). Similarly, in the "Company D" case study, the main driver of the decision to tender was the previous auditor seeking a substantial increase in fee unrelated to changes in the company's business and this was a trigger for the company to test the market (paragraph 16).

²⁰ See, e.g., the "Company E" case study, where the ACC said that although the company was a unique business "this did not hinder the effectiveness of benchmarking as there were similar companies in terms of size and complexity to which

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committee chairs (ACCs) are experienced purchasers and have a good understanding of audit markets.²¹ They can and do make comparisons with audits offered to companies of a similar size and in the same or similar business sectors.²²

- (iv) In common with many (perhaps most) services supplied to large companies, the fact that the audit fee is a relatively small element of the total costs of a large company is no reason to deduce that the company is not interested in exercising proper cost control.²³ As above, the CC's data shows clearly that companies have squeezed audit costs, as is consistent with the competitive pressures they themselves face. Indeed, audit costs are particularly susceptible to such control given that they have to be agreed on, and justified internally, on an annual basis and are likely to be a relatively large item in a FD's budget.²⁴
- (v) While the CC's survey suggests that there may be a difference of emphasis as regards the respective positions of the FD and ACC on the price of the audit, with the FD relatively more focussed on ensuring the price represents good value to the company and the ACC relatively more concerned to ensure that the auditor can perform a high quality audit for the fee. However, this difference should not be exaggerated. Both the FD and the ACC take their corporate governance responsibilities seriously, including - for both roles - ensuring that the company receives a high quality, value for money service.²⁵

to compare the audit fee" and given "the ACC's vast sector experience he also had contacts at other companies he could talk to about fees." (paragraph 60 of the Company E case study)

²¹ See paragraph 5.23 of our Initial Submission setting out evidence of companies periodically benchmarking audit fees against comparator companies and applying competitive fee pressure as a result. See also paragraph 1.32 of our Initial Submission referring to the informal information available through the network of AC members and FDs who regularly move between companies (or have board roles in several companies simultaneously) and are able to judge the performance of auditors and their value proposition through first-hand experience. Annex 8 to our Initial Submission sets out the experience of audit committee members and CFOs.

²² According to the CC Survey Presentation, 79% of FTSE 350 companies named "fee comparisons" as a factor in benchmarking - by far the most cited factor (see slide 47 of the CC Survey Presentation).

²³ See Section 5B of our Initial Submission setting out examples from our experience of how keenly companies review and contest audit prices.

²⁴ See our Initial Submission, paragraphs 5.10 and 5.11, where we set out that it is not unusual for a FTSE 350 company's audit fee to exceed £1 million and that this is often the largest item in the FD's direct budget meaning that s/he (as the individual who sets and enforces cost controls across the business) will be under pressure to demonstrate that the fee represents value for money.

²⁵ See CC Survey Presentation, slides 26 and 28 in relation to aspects of audit quality valued by FDs and ACCs and slide 46 in relation to regularity of audit fee negotiations, benchmarking, and auditor performance reviews.

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(b) Switching auditors incurs costs for companies that outweigh gains:

- (i) Although switching auditors can involve relatively substantial costs for the company, these costs are not so high as to prevent a company from switching if it is dissatisfied with the audit service.²⁶ In such circumstances, the company would expect to gain an improved audit service in terms of better value for money and/or quality.
- (ii) The evidence is clear that where companies believe that the audit firm is failing to provide a competitive audit (in terms of quality, service levels and/or cost) then the switching costs associated with undertaking a tender process and educating a new audit team as to the business do not prevent a switch from taking place.²⁷
- (iii) If audit firms were providing companies with low quality or highly priced audits, then we would see higher tender and switching rates. That we do not, and that the evidence from companies and case studies show companies are not concerned in this respect²⁸, demonstrates that the market is delivering competitive outcomes (as set out in our Fourth Pillar).²⁹

(c) At certain times switching may be impossible or undesirable:

- (i) While it is never impossible for a company to switch auditor, the times when it would be highly undesirable for a company to switch auditor - for example, because the company is involved in a significant acquisition or restructuring process - are invariably short-lived. Any audit firm that sought to take advantage during this temporary period (by increasing price or reducing quality) would likely face a tender process as soon as circumstances allowed,³⁰ as well as damaging its wider reputation in the market given the frequency with which executives move between companies or hold cross-directorships.
- (ii) Switching auditor is regarded as an unremarkable occurrence and absent special circumstances - such as an audit firm resigning unexpectedly over concerns with the

²⁶ For example, it was stated in the "Company G" case study that *"if the company thought that another audit firm could provide a better service at a lower cost and with a greater degree of independence, then this would trigger a switch"* (paragraph 22).

²⁷ For example, the "Company G" case study shows that companies are willing to incur switching costs if unhappy with the quality of the audit service: the ACC noted that *"switching auditor would be a huge exercise and had a huge risk associated with it"* and would be *"a major disruption to the company and would divert significant amounts of management time"*, but that the company would tender if it thought that the quality of the team being allocated to its audit was not adequate and that over a period of time the audit firm had not responded to the company's needs and complaints (paragraphs 65 and 69). Note also that the CC Survey Presentation (slide 67) suggests internal switching costs are often not significant.

²⁸ See for example, the Fund Accounting Manager in the "Company J" case study who stated that *"if [the current auditor] was doing a good job then there was no reason to switch"* and that the company's preference would be to *"stay with an audit firm providing a good service rather than take the risk of switching"* (paragraph 17).

²⁹ See Section 6 of our Initial Submission where we set out our Fourth Pillar (*"The market operates effectively"*).

³⁰ For instance, the "Company C" case study shows the company went through a period of great transformation, during which it changed all of its advisors but it was not thought sensible to change auditors during that time as there was so much going on in the group; however, once this was over, the *"slightly difficult relationship with the previous auditor [was] such that a tender was inevitable"* (paragraph 58).

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financial statements or switching taking place very frequently - no negative signals are likely to be sent about the company's performance by a change of audit firm.³¹

(d) Certain aspects of audit quality are not readily observable by those deciding to (re)appoint auditors:

- (i) The ACC and the FD of large companies have the experience (obtained throughout their careers, often as ex-auditors and from holding various corporate positions³²) to "*know what good looks like*"³³ which means that they are more than capable of observing and assessing audit quality.
- (ii) We agree with the CC's initial view that management and the ACC have a high degree of visibility on many aspects of the technical quality of the audit and the quality of service.³⁴ For this reason they can recognise when audit quality is falling short of their expectations (and are prepared to tender to seek improved quality) as well as observing quality gains obtained from switching. The CC's case studies and survey also show clearly that FDs and ACCs understand and are able to judge audit quality, with reviews of audit quality and the value of service provided carried out annually by 91% of FTSE 350 companies.³⁵
- (iii) There is no basis to sustain a theory that price may be seen as a proxy for quality such that large companies are reluctant to switch audit firm on cost grounds to avoid any perception that this might signal lower audit quality to the market.

(e) Big Four background of most ACCs and FDs may limit perception of auditor choice:

- (i) To the extent that ACCs and FDs have a background with the four largest firms, this experience helps to equip them with the expertise and ability to assess audit quality and make informed decisions as to which audit firm represents the most appropriate choice for the company.
- (ii) In fact, many ACCs and FDs do not have such a background or left one of the four largest firms only a relatively short period after qualification.

³¹ For example, this was shown in the Blackrock case study: "*From the Investors' perspective, a change of auditor had no impact and largely went unnoticed. It was not therefore in itself a cause for concern except in extremis where the audit firm had resigned and put out a statement highlighting particular concerns.*" (paragraph 18)

³² See Annex 8 to our Initial Submission in relation to the experience of audit committee members and CFOs.

³³ See paragraph 21 of the "Company E" case study: "*The FD and his Head of Group Reporting Accounting were both former auditors, and the Head of Tax was ex-profession, therefore they 'know what good looks like'. If the auditors were not up to scratch then they would be replaced.*"

³⁴ RIS, paragraph 63.

³⁵ See slide 46 of CC survey report. See also, for example, the CC case studies on "Company J" where the Fund Accounting Manager stated that he had clear visibility on the auditor's work (paragraph 9); "Company I" where the FD set out the criteria against which the company would conduct an annual assessment of the performance of its auditor (of over twenty years) (paragraph 17); and "Company H" which had a "*technical 'guru' who debated 'quite hotly at times' with the audit team the correct accounting policy for certain items*" and formally assessed auditor performance annually, with the ACC stating that "*EY was not in place for ten years irrespective of its performance. Reappointment was not taken for granted and the Audit Committee was 'on their case'.*" (paragraphs 14 and 65).

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- (iii) Regardless of their background, ACCs and CFOs have clear duties to ensure they obtain the best possible audit service for the company and its shareholders. The evidence suggests that ACCs and FDs have often experienced the mid-tier firms directly and actively consider whether the mid-tier firms should be invited to any tender of the audit.³⁶ We are not aware of any evidence of ACCs or FDs acting out of misguided loyalty³⁷, and the CC's survey shows clearly that such factors do not influence the decisions of ACCs and FDs.³⁸

Supply side characteristics (paragraphs 77 and 78 of the RIS)

(a) The extent of rivalry between audit firms before, during and after tenders:

- (i) Competitive pressure to produce a high quality and value for money audit is continuous. Companies closely monitor both aspects and push for improvements, with the implicit threat of tender where necessary.³⁹ To examine the extent of rivalry between audit firms solely or primarily by reference to formal tenders, as paragraph 77 of the RIS seems to imply, is to ignore this reality.
- (ii) We constantly compete to win and retain business in the reference market, with each win for us being a loss for one of our major competitors. To retain and improve our market position, we continuously need to replenish our FTSE 350 market share by targeting the audits of likely new entrants to the FTSE 350 and companies we do not currently audit which are in a situation which may trigger a tender (e.g. the rotation of the audit partner, known issues with the existing auditor, change of management or AC personnel).⁴⁰
- (iii) From our perspective, for all bar [redacted] of those FTSE 350 companies where we are not the auditor, we are either actively targeting the audit, or would be able and willing to tender should the opportunity arise.⁴¹ We have various initiatives to target new clients where we

³⁶ Indeed, 30% of FTSE 350 companies invited at least one mid-tier firm to tender (see slide 54 of the CC Survey presentation).

³⁷ See our Response to Third Parties, paragraph 4.9, where we explain that if the audit firm's service delivery was to fall short of what was expected, or if such firm started to lose its market reputation for competence, it would be foolhardy and irrational for ACCs/FDs to risk their own and their company's reputation out of misguided loyalty.

³⁸ See slides 37 and 42 which show that for both ACCs and FDs, '*Management preference for a specific auditor*', and '*Relationship with the audit firm*' are the least frequently mentioned factors when (re)appointing an auditor.

³⁹ See, e.g. our Initial Submission, paragraph 5.4, which sets out examples of companies exerting pressure on audit costs, or slide 46 of the CC's survey report detailing steps taken to monitor and challenge audit quality and price.

⁴⁰ See our Initial Submission, paragraphs 4.4 - 4.23, explaining that apparently static market shares disguise the significant "churn" of companies entering and exiting the FTSE 350 and the constant effort made by audit firms to retain market share by competing to win audits for companies that enter (or have potential to enter) the FTSE 350 as well as the audits of companies switching within the FTSE 350. This churn is shown in detail in the infographic available on the PwC website at <http://www.pwc.co.uk/who-we-are/the-uk-statutory-audit-market-infographic.jhtml>.

⁴¹ See our Initial Submission, paragraph 4.52(c), where we explain that [redacted]. However, as was the case with our recent [redacted] audit win, it is possible to disentangle the firm from any company should the situation require it. See also our response to Q54 MFQ.

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are not currently the auditor, and we know our competitors have similar initiatives in place.⁴²

- (iv) The relative rarity of large company audit tenders means audit firms compete fiercely to win the appointment when a tender arises. We, and our competitors, go to great lengths and expense to demonstrate that we can offer the best service and value for money in tenders.⁴³
- (v) Once an engagement has been won it is clear that should standards fall below those expected the company may switch again. This pressure is brought to bear by companies during the annual scope and fee negotiation and audit effectiveness review undertaken prior to reappointment.⁴⁴ On switching, companies may negotiate a fixed price or overall costs structure for the audit over a two or three year period, such that the audit firm is unable to increase its fees during this period unless the scope of the audit increases.

(b) The nature and extent of barriers to entry and to expansion:

- (i) Given the strong competition between at least four large audit firms to supply audit services to the FTSE 350, the existence or otherwise of barriers to entry and expansion is of limited relevance.
- (ii) We will respond separately to the CC's Framework on Barriers to Entry working paper dated 17 August 2012.

⁴² See our Initial Submission, section 4C, where we set out information on our Tanks on Lawns, Mid-cap programme, Velocity and Net 635 initiatives; see also our MFQ response, Q93, Q97.

⁴³ See our Initial Submission, paragraph 5.43, where we set out the steps we take to win appointments in a market where tenders occur relatively infrequently and audit firms compete fiercely to win the appointment.

⁴⁴ See our Initial Submission, Section 5D, where we set out how companies exert competitive pressure on their auditors outside the context of a tender process and rely on the threat of tender and switching to back up their demands.

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Second revised theory of harm: Principal - agent issues

As explained in paragraph 8(b) of this response, we do not agree with the way these issues are introduced in the RIS, in particular because of the inappropriate and unsupported assumption of a misalignment of incentives between, on the one hand, auditors and/or ACs, and shareholders on the other. Nevertheless, we have addressed the aspects identified by the CC in paragraph 83 (a) to (e) of the RIS for further investigation below.

(a) The FD, AC and ACC are primarily responsible for the appointment of the auditor

- (i) The central role of the FD, AC and ACC in recommending an audit firm for (re)appointment by the shareholders is entirely appropriate. Shareholders comprise a potentially large and disparate group who are not involved in detailed oversight of the audit process and cannot be as well placed to judge the quality or value for money of the audit service as those who engage actively with the auditors throughout the year. Indeed, as investors recognise⁴⁵, there are good reasons (including insider dealing rules) which prevent them being more heavily involved.
- (ii) The evidence to date, including the CC's survey and case studies, shows that ACCs and FDs are engaged with the audit process and act in accordance with their duties to the company and the shareholders.⁴⁶ They place value on the quality, objectivity and independence of the audit above other characteristics.⁴⁷ There is no evidence to suggest a systemic failure whereby those entrusted to act on shareholders' behalf in supervising the audit process fail to do so.
- (iii) While auditors have very limited direct interaction with shareholders, we are scrutinised on their behalf in particular by the AC. We take our responsibility to the shareholders very seriously given our legal duties, how we carry out our work on a basis of unlimited liability⁴⁸, and the risk to our reputation should we fail to do so. Given the critical value of reputation to audit firms and individual auditors, this risk cannot be understated.⁴⁹

⁴⁵ See, e.g. paragraph 3 of the BlackRock case study.

⁴⁶ For example, in the "Company D" case study, the ACC acknowledged the importance of the AC and stated that its role "was to address any issues that were raised as a result of the audit process and to act as a safeguard between the management and the shareholders to help the shareholders to have some confidence that the numbers are true and fair." (paragraph 57)

⁴⁷ See slides 27 and 29 of the CC Survey presentation which show "Independence of the audit firm", "Ability to detect misstatements", "Efficiency of the audit process" and "High degree of challenge" as the most important factors for both ACCs and FD when assessing audit quality. Similarly, for example, in the "Company G" case study, the Group Financial Controller, in the context of a thorough questionnaire that was sent each year to around 40 or 50 people around the company who had the main contact with the auditors during the process to monitor performance, said that "in terms of the qualities that he required from an auditor, he considered independence, and quality and expertise, to be prerequisites. Following this, he looked for value for money and efficiency." (paragraphs 17 to 20).

⁴⁸ See our MFQ response, Q84.

⁴⁹ The RIS acknowledges that importance of reputation may mitigate the risk of auditors acting against shareholder interests (paragraph 68), and we have covered the importance of reputation in more detail in section 4 of our Response to Third Parties.

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(b) The AC is a regulatory remedy to the principal-agent problem that may introduce further principal-agent issues⁵⁰

- (i) The purpose of the AC is to act in the interests of shareholders and ensure that audits are conducted for shareholders' benefit. This role has come about in response to the information asymmetry identified by the CC between shareholders and the auditor, and has evolved by design in accordance with regulator views and market needs.
- (ii) There is no misalignment of incentives between the shareholders and the AC such as to introduce new principal-agent concerns, given that the specific role of the AC is to represent the shareholders' interests in respect of the audit. The evidence, including the case studies and CC survey, shows that this is a role that AC members take very seriously and perform to a high standard.⁵¹
- (iii) There are no significant constraints in terms of time and resources on ACs that might prevent them achieving their objectives.⁵² Following the introduction of the new Combined Code and the accompanying Smith Guidance in 2003, the acknowledgement of the increased role for ACs has led to individuals spending greater time on AC duties and receiving increased fees to recognise their increased contributions.
- (iv) We recognise that the role of the AC could evolve - particularly in terms of the detail reported to shareholders - to give shareholders greater transparency on the audit process, and through our *Progressive Agenda* initiative, we have had a leading role in encouraging this.⁵³

(c) Management and AC decisions to (re)appoint an auditor may be based on indicators or proxies for unobservable variables rather than underlying audit quality

- (i) Those with the primary responsibility for making purchasing decisions about audit services (FDs and ACCs) are invariably experienced and knowledgeable individuals who are well placed to assess audit quality. They are not limited to making their decisions based on simple and obvious visible indicators such as the identity of the firm.
- (ii) The evidence they can rely on includes that of previous audits by the current audit firm; audits they have experienced by other audit firms; reports from regulators such as the AIU; the experience of fellow directors and employees; and the experience of colleagues in other companies.

⁵⁰ In the RIS paragraph 83(b) refers specifically to the ACC, but we believe the CC is likely to consider the role of the entire AC in this respect.

⁵¹ For example, see the "Company E" case study where the ACC stated he spends one day preparing for each of the formal AC meetings and that although he estimated the draft audit papers to be 100 pages long, "*his greatest incentive to complete the job diligently was that he was 'putting his reputation on the line'*" (paragraphs 47 and 48).

⁵² For example, see the "Company D" case study where the ACC confirmed that the AC had the resources and expertise to scrutinise the current auditors and management. (paragraph 56)

⁵³ See our Response to Third Parties, paragraph 2.19 and footnote 42, and the paper *The Progressive Agenda - Increasing Corporate Transparency in the Audit Committee Report* provided as Exhibit 5 to that paper.

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- (iii) The CC's survey showed that FDs and ACCs had experience not only of the large firms but also smaller audit firms, and that smaller audit firms were also often invited to tender, although seldom successful.⁵⁴
 - (iv) An audit may have some of the characteristics of an "*experience good*" in that a company cannot know at the time of appointment whether the auditor will make an error or that quality and service levels will be satisfactory in the upcoming year. However, in this regard the audit is no different from any other purchase of a service, and this does not mean that auditor appointments are made "blind" or that the company cannot take action quickly to address underperformance.
- (d) There is potential misalignment of interests between those appointing the auditor and those using the output**
- (i) The way this issue has been characterised in the RIS risks over-simplifying the interests of those involved in the audit process. It is wholly artificial to separate the efficiency of the audit process from the quality of the output. An efficient audit process and a quality outcome are both in the interests of all stakeholders involved in the audit process.⁵⁵
 - (ii) Any suggestion that for an auditor to have a good working relationship with management (as valued by management) is in some way at odds with delivering a high quality audit service (as valued by shareholders) is incorrect. In order to deliver a quality audit service, an efficient and good working relationship with management is important. The two features are complementary, not mutually exclusive.
 - (iii) Likewise, while it is correct that management will wish to receive an efficient audit service and have a good working relationship with the auditor, they also require the audit firm to deliver an accurate and high quality audit. If there are mistakes in the financial statements that are not uncovered by the audit, this reflects badly on management and the AC (who are accountable to shareholders at the AGM) as well as the auditors. The CC's survey showed that FDs and ACCs regard a robust, independent audit as the most important audit characteristic - which is in line with the view of investors⁵⁶. Similarly, shareholders are not only concerned with the quality of the audit output but have an

⁵⁴ 30% of FTSE 350 companies invited at least one mid-tier firm to tender (see slide 54 of the CC Survey Presentation). However, as slide 62 shows, within the FTSE 350 the mid-tier did not win any audits from Big Four firms while Big Four firms won over 80% of tenders where a mid-tier firm was the previous auditor (this situation was not markedly different outside the FTSE 350 with 93% of tenders where the previous auditor had been a mid-tier firm moving to a Big Four firm).

⁵⁵ The CC Survey Presentation (slides 26 and 28) show both efficiency and other factors relating to audit quality such as independence, challenge, and ability to detect misstatements to be most highly valued by FDs and ACCs.

⁵⁶ See for example paragraphs 35 to 37 of the BlackRock case study.

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interest in the audit being conducted efficiently in order to minimise costs where possible.⁵⁷

(e) Legislation and regulation may have an impact on the nature of the statutory audit

- (i) It is correct that certain specifications for the audit and auditor are set out in legislation and regulation, which are prescribed for sound regulatory reasons. These regulations have developed the way they have to protect the investor and thus overcome any potential problems associated with the information asymmetries between auditors and investors. It therefore seems counterintuitive to refer to the regulatory framework as a problem.
- (ii) Notwithstanding its extent and importance, the regulatory regime does not provide a definition of what constitutes a high quality audit and our experience is that an audit for a large company will go well beyond mere compliance with the published standards.⁵⁸
- (iii) Indeed, competition in the market means that we are always looking for ways to innovate and provide companies with additional value through the audit process, and the evidence shows we do exactly that.⁵⁹

⁵⁷ See our Initial Submission, paragraph 7.44, where we set out that it is in the interest of all parties to ensure that the company has the benefit of a high quality and value for money audit to ensure the company operates efficiently and is more likely to give value to investors.

⁵⁸ See our Initial Submission, paragraphs 1.5-1.6, 1.18, where we set out that an audit is a highly technical professional service that requires the exercise of judgement.

⁵⁹ See our Initial Submission, Section 5B, where we set out how we seek to differentiate our audit service. See also our Response to Third Parties, paragraphs 3.9 - 3.13, where we set out evidence that audit quality and innovation is high and how we in particular have sought to: (i) help companies improve the relevance and reliability of their corporate reporting; (ii) enhance the quality and efficiency of the audit process (e.g. through the delivery of our Audit Transformation Programme); and (iii) differentiate the audit service within the boundaries of the regulatory model, including by adding value during the audit process so as to improve company performance. See also our response to MFQ 103, setting out details of specific examples of innovation in our audits.