Views of investors and other stakeholders

1 This paper sets out our comments on the Views of investors and other stakeholders working paper (the **Investor Views WP** or the **Paper**). The CC's overall summary of the position of investors (as set out in paragraphs 78 and 79) is that there is broad consensus with regard to the role of audit and investor influence but that the responses from investors to the CC's questionnaire and in the other evidence submitted to this investigation were more mixed with regard to the importance of auditor identity, the effect of changing auditor and whether or not more information should be provided to investors.

2 In very broad terms, this summary reflects our own experience of the views of different investors and other stakeholders. Investors do not have a uniform perspective on the best methods for ensuring good corporate governance and the role of auditors in that process, and their level of understanding of the detail of the audit process varies considerably. As the CC has correctly recognised, shareholders - as owners of FTSE 350 companies - are the ultimate customer of audit firms, but the complexity of auditing such companies means that audit committees (**AC**s) are required to oversee the provision of the audit on their behalf.[1]

3 A key question in respect of the CC's second theory of harm is whether the AC is effective and acts in the interests of shareholders. We do not believe the CC has gathered any evidence of a misalignment of interests between ACs and shareholders. Indeed, we consider that the evidence demonstrates that investors' interests in receiving a competitive audit service are well-protected by the AC.[2]

4 In this response, we focus on setting out our high level position in respect of each of the main points dealt with in the summary section of the Paper. In the Annex to this paper, we address some points of detail.

Common ground among investors

5 Paragraph 78 of the Paper covers two points that the CC suggests are common ground among investors:

(a) **The audit is valuable to investors:**

(i) We agree that the audit process and resulting financial statements are highly valuable to investors, and that the process is regarded by investors as in many

---

1 That ACs have greater visibility of the audit process than shareholders is illustrated in the CC's own diagram (see Figure 1 of the CC's working paper on the Nature and strength of competition in the supply of FTSE 350 audits (**NSCP**)).

2 The evidence to date, including the CC's survey and case studies, shows that ACs are experienced and knowledgeable (as recognised in the NSCP - see, for example, paragraphs 74 to 76) and that they are engaged with the audit process and act in accordance with their duties to the company and investors (see for example the "Company D" case study, where the ACC emphasised the purpose of the AC in acting in the interests of investors stating 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)). Similarly, the CC's evidence to date also demonstrates that ACs take their role in representing investors' interests very seriously: see, for example, 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).

respects more valuable than the audit report itself - although note that the impact of a qualified audit opinion is highly significant.[3]

(ii) Given the value placed by investors on the audit process, we do not recognise or accept the suggestion at paragraph 69 of the Paper that Institutional Investors regard the audit as a "*utility product*" or that it is "*no longer differentiated on the basis of quality as very little judgement was required when undertaking an audit*". While some investors may have expressed this view, it is not consistent with our own experience that investors understand that the audit of large companies is complex and involves the exercise of often significant judgement over a wide range of issues (including those subjective issues that are referred to in paragraph 68).[4] Furthermore, ACs are much closer to the audit process and are able to assess the capabilities of the audit firm in exercising judgement.

(iii) We recognise that audit firms are not able to differentiate themselves in the production of the audit report itself because a standard form and content is currently prescribed by regulation and auditing standards. However, the experience and quality of the auditor in conducting the audit, and the exercise of judgement in reaching the audit opinion, means that it would be wholly incorrect to characterise, on that evidence, the audit as a utility or incapable of differentiation on the basis of quality.

(b) **Investor influence is very limited:**

(i) We recognise the general picture presented in the Paper from investors that in practice they exercise relatively little direct influence at the AGM and that to the extent they have issues they wish to raise with the company, including in respect of the auditor, there is a better chance of influencing management prior to the AGM.

(ii) However, it is worth noting that notwithstanding the views expressed in paragraph 53 of the Paper, investors have certain rights that are available to them under the Companies Act[5] and investors are able to influence companies (through

---

3 See for example our Audit Today and Tomorrow survey (April/May 2011) (submitted in response to the CC's initial request for off-the-shelf material as B.10.1) where one of the key messages was that the audit affects investment decisions, but that audit reports themselves do not give meaningful information: "*A total of 81% of those interviewed strongly agree or agree that they would be unlikely to invest in a company if the audit report indicated that the accounts were not true and fair. Investors and analysts clearly take comfort from a 'clean' audit report when making decisions about companies. There is an apparent paradox here: the fact that there has been an audit is critical for investment decision-making, but…the existing wording of the opinion does not communicate the value of an audit either sufficiently clearly or sufficiently promptly.*" (page 10). This finding is not restricted to UK investors, as a similar result was found when we extended this survey to include 104 investors and analysts from 11 capital markets (see our Assurance Today and Tomorrow survey (September 2012).

4 For example, in the Legal and General Investment Management case study (see paragraphs 28 and 31) it was clear that although "*[t]he Investor was not able to judge the quality of an audit directly*", it went on to say that it "*was able to tell the quality of the accounts in a more nuanced way, by analysing the accounts and considering the company's approach to accounting policy. It was possible to tell whether a company had adopted policies that meant it was 'sailing close to the wind' and the stock market put different valuations of companies based on this perception*." Legal and General Investment made it clear that quality of audit is discernable and that they "*looked for clarity, consistency and transparency in the audited accounts*".

5 For example, section 527 of the Companies Act 2006 allows shareholders to send a request to the company requiring it to publish on its website a statement setting out any matter that the members propose to raise at the next AGM relating

representations made to the Senior Independent Director (SID), the audit committee chair (**ACC**) or to management) in respect of the audit process.[6] Indeed, investors have demonstrated recently that they are able to influence the approach that large companies take to remuneration through such mechanisms.

(iii) As we have explained in detail in our Response to Certain Third Parties' Submissions (see paragraph 3.10 and Box 3 on Building Public Trust), in recognition of the relative lack of direct engagement / interaction with investors in the audit process, we have innovated to develop various outreach programmes to engage with investors to better understand their views and to seek to ensure, so far as possible, that we are meeting investor demand. In recognition of the extent of influence of regulation and standards on what we are able to do, we also share what we have heard from investors with regulators and accounting and auditing standard setters so that it can inform their thinking. These initiatives include our "Audit today and tomorrow" survey, "Meet the Auditor" meetings, the "Auditor view" publication series and our facilitation of the Corporate Reporting User Forums. Our public Audit Quality and Transparency Report also provides insight into how we approach and manage audit quality.

Mixed views from investors / end-users

6 Paragraph 79 of the Paper then addresses three points where investors expressed mixed views:

(a) **Auditor identity:** We note that a minority of investors regard the four largest firms as better than other audit firms, some investors consider the four largest firms to be better able to audit FTSE 100 companies but most are comfortable with a larger mid-tier firm auditing FTSE 250 companies. In relation to these observations we note that:

(i) It is important to recognise that in the context of assessing the relative attributes of different audit firms, investors (by their own admission) are not closely involved in the audit process and so may not have sufficient information to judge the relative capability and suitability of different audit firms for appointment to a particular company. This is why the process of selecting an audit firm for recommendation to the investors is undertaken by the AC, with involvement from the finance director (**FD**) and others.

---

to the audit of the company's accounts (including the auditor's report and the conduct of the audit) or any circumstances connected with an auditor of the company ceasing to hold office since the previous accounts meeting.

6 For example, in the Legal and General Investment Management case study it was made clear that "*the Investor thought that its views were listened to and that it had influence*": previously, the "*Investor had voted against management's recommendation to reappoint the auditor in cases where there had been an issue with the accounts*"; their "*approach was to try to influence the Board prior to the AGM rather than wait until the annual vote"; they would regularly meet "the CFOs of companies to discuss and better understand accounting treatment (including treatment of leases, capitalization policy etc)*"; and they "*were able to push companies to explain how their accounting treatment differed from peers and in some cases were able to use this influence management to better align accounting policies with the rest of the industry.*" See paragraphs 7 to 11 of the case study.

(ii) To the extent that some investors have expressed the view that they would not object to the appointment of certain mid-tier audit firms, we note that many large companies are currently using mid-tier firms for non-audit services[7] and that mid-tier firms are invited to a substantial number of audit tenders.[8] This shows that large companies are not biased against potentially appointing mid-tier firms as auditor, and demonstrates that large companies are not acting under a misapprehension of investor views. Rather, the relatively small numbers of mid-tier firms auditing large companies demonstrates that when compared directly against the four largest firms they are not usually selected by sophisticated purchasers who are able to judge the relative attributes of the different audit firms.[9]

(iii) As we have previously explained (in our Submission and Response to Issues Statement (our **Initial Submission**)[10] and more recently in our response to the CC's working paper on Reputation),[11] we recognise that mid-tier firms are potentially capable of auditing some large companies. However, the fact that mid-tier firms may be technically competent to conduct an audit does not mean they are the best choice for the company. This is because mid-tier firms may not be able to offer a combination of technical and service standards that matches those of the four largest firms, which have superior attributes which objectively differentiate them when competing for work from FTSE 350 companies.

(b) **Change in auditors:** We agree with the view that provided the reasons for a change of auditor are explained in the usual course of business, switching auditor would not be a cause for concern. Of course, should a company change auditor more than once in a short period of time, this is likely to lead to queries from investors to understand the reasons for this.

(c) **The need for and nature of more disclosure/different outputs from the audit process**: We note the wide range of views expressed by investors, from those that want no further disclosure or different outputs from the audit to those that want more information, for example about the areas of judgement exercised by the auditor.[12]

(i) We have explained in our Response to Certain Third Parties' Submissions that we recognise there is potentially unmet demand from investors for greater insight from the audit process. We set out below paragraphs 2.17 to 2.19 of our Response to Certain Third Parties' Submissions, which address this issue in detail:

---

7 The mid-tier firms have existing relationships with many of the FTSE 350 companies. For example, in the year ended December 2011, Grant Thornton provided non-audit services to 36 FTSE 100 and 66 FTSE 250 companies.

8 The CC's Survey shows that mid-tier firms are invited to participate in 30% of tenders and therefore have the opportunity to demonstrate their capabilities to a significant proportion of large companies (see slide 54 of the CC's Survey).

9 See slide 62 of the CC's Survey which shows that the largest four firms win significant proportions of audits from the mid-tier both within and outside the FTSE 350. Within the FTSE 350, the mid-tier won no audits from the largest four firms, and lost about 76% where they were the incumbent auditor in competition with the largest four firms.

10 See paragraph 7.14 of our Initial Submission.

11 See paragraph 10 of our response.

12 See for example section 5 of the Institutional Investor Committee (IIC) paper of 3 December 2012 - http://www.iicomm.org/docs/EU_Audit_proposals.pdf

2.17 *Investor representatives have been forthright in their submissions that they would like more access to information in the auditor's report,[13] and that there could be further innovation in this respect (although we believe that different groups of investors have different perspectives on such matters). While we support more transparent reporting,[14] as discussed above, we do not believe the current reporting framework has any negative implications for audit quality and competition. We have every incentive to ensure shareholders understand and appreciate the work we do. As we explain below, we have been strong advocates of further improvement in audit reporting for many years and it is therefore demonstrably incorrect to suggest that there is little appetite among audit firms to go beyond today's reporting model to provide greater transparency into the audit process.[15]*

2.18 *As described above, changes in audit reporting have been necessarily limited because of the prescriptions of regulation - in particular ISA (UK&I) 700, which prescribes a strict format and limited level of disclosure in the auditor's report (see Box 1 [of our Response to Certain Third Parties' Submissions]). Despite this, we have engaged in dialogue with shareholders, companies and regulators to seek to broaden the scope of the audit and to give rise to more informative audit reporting. For example, we (and representatives of the FRC) are actively engaged in the international IAASB project on auditor reporting, and encouraging regulatory change to enable greater audit reporting.[16] Furthermore, the APB is currently exploring the possibility of the auditor commenting in the auditor's report if the audit committee disclosure does not appropriately address matters communicated by the auditor to the audit committee[17] and this is something that we believe should be actively explored.[18]*

2.19 *Given the prescriptions of international regulation affecting the potential change to the auditor's report, we note that the investor representatives recognise that "the more important thing to develop at this stage [is] the Audit Committee report".[19] In this respect, as investors have recognised, with our encouragement a number of companies that we audit have increased disclosure of audit-related information in their annual reports.[20] Six of the FTSE 100 companies that we audit have included an expanded report by the audit committee in their Annual Report, and more companies have said they intend to do so this year. This*

---

13 Summary of Investor Hearing (paragraph 21), USS Submission (page 9).

14 See PwC Chairman Ian Powell's 2010 speech "Building Public Trust" (BPT Speech) [provided as Exhibit 4 to our Response to Certain Third Parties' Submissions].

15 Hermes Response to Issues Statement (page 2).

16 See for instance the PwC response to the 2011 IAASB consultation on the future of auditor reporting: "*the time is right to significantly enhance auditor reporting. Users' needs are more clearly articulated than ever before. Responding to these needs is critical to maintaining the value and relevance of the audit. Valuable enhancements can be made now that move us some way to achieving the goal of more informative and valuable auditor reporting. More radical solutions will require comprehensive reform in corporate reporting and corporate governance*." See http://www.pwc.co.uk/assets/pdf/iaasb-auditor-reporting-consultation-pwc-response-letter.pdf (page 8).

17 See http://www.frc.org.uk/getattachment/cf1f2c07-b64e-40bb-bcbb-51f639760978/Consultation-Paper-Proposed-Revisionsto-International-Standards-on-Auditing-(UK-and-Ireland).aspx , in particular paragraphs 6(c)(ii), 22 and a20(b).

18 See PwC's comment on the earlier FRC consultation that tested the waters on the proposals dated 31 March 2011 ("Effective Corporate Governance -- Enhancing Corporate Reporting and Audit") at http://frc.org.uk/Our-Work/Publications/FRCBoard/Effective-Company-Stewardship-Enhancing-Corporate/Responses-to-Effective-Company-Stewardship-Enhanci/PricewaterhouseCoopers-LLP.aspx.

19 See Summary of Investor Hearing (paragraph 6). See also Box 1 [of our Response to Certain Third Parties' Submissions].

20 See the Paper entitled "*The Progressive Agenda - Increasing Corporate Transparency in the Audit Committee Report*", dated 7 June 2011, provided as Exhibit 5 [of our Response to Certain Third Parties' Submissions] which sets out at page 1 our successes in encouraging more transparent corporate reporting in relation to the financial statements. We note that the institutional investors recognise (Summary of Investor Hearing (paragraph 14)) the efforts made by Barclays to improve the detail in recent annual reports. Barclays had set out five key issues that were discussed with the external auditors, including a valuation of credit market exposure and the impairment testing of goodwill. Similarly, GKN and Man Group made additional disclosures in 2010 and 2011 respectively through their audit committees and mentioned PwC's involvement in this process in their respective audit committee reports.

expanded report gives much more insight into the audit process, the dialogue that takes place between auditor and the audit committee and the value that audit adds, as well as providing information on how auditor independence is assessed.

(ii) To the extent that there is unmet demand for investors in relation to information about the audit, this reflects the regulatory framework and many companies' reluctance to disclose more information about the audit. However, this does not reflect any failure of competition in the audit market. We believe that through our initiative with companies and those of regulators referred to above, a consensus can be achieved on improved reporting about the audit that will accord with the view of the majority of investors.

(iii) Indeed, since our Response to Certain Third Parties' Submissions, the FRC has finalised and released its Effective Company Stewardship proposals and some of things encouraged last year will now be mandated (for example, enhanced AC reports and auditor reporting thereon).[21]

Theory of Harm 2[22]

7 Finally, we note that the CC is no longer producing a separate working paper on principal / agent issues, notwithstanding that the CC has expressly left open the critical issue of whether or not the interests of auditors and ACCs are sufficiently aligned with those of shareholders and broader stakeholders for principal-agent problems to arise in practice.[23] In our view, to reach a finding that there is such a misalignment of interests would require substantial evidence to show that auditors and/or ACCs are acting contrary to the interests of shareholders and in breach of their regulatory, statutory and/or contractual obligations. This is a high evidential threshold and we are not aware of any evidence to substantiate this theory of harm.

PricewaterhouseCoopers LLP

4 December 2012

---

21 See the FRC's *"Guidance on Audit Committees*", dated September 2012, which recommends that the audit committee section of the annual report should include an explanation of how the committee has assessed the effectiveness of the external audit process and of the approach taken to the appointment or reappointment of the external auditor, in order that shareholders can understand why it recommended either to reappoint or change the auditors (paragraph 4.26). It should also include the significant issues that the committee considered in relation to the financial statements and how these issues were addressed, having regard to matters communicated to it by the auditors (paragraph 5.2). International Standard on Auditing (UK and Ireland) 700 (Revised October 2012), *"The Auditor's Report on Financial Statements",* which is effective for audits of financial statements for periods commencing on or after 1 October 2012, requires the auditor to report by exception if the section describing the work of the audit committee does not appropriately address matters communicated by the auditor to the audit committee and, if the annual report does not appropriately disclose any matters communicated by the auditor to the audit committee that in the auditor's judgment should have been disclosed, or if the annual report does not contain such a section, the auditor's report shall also include any such information (paragraph ISA 700.22B)

22 We have set out our position on the second theory of harm at paragraphs 7(b)(i)-(viii) (and pages 11-14 of the Annex) of our response to the Revised Issues Statement dated 7 September 2012.

23 See the CC's email of 21 November 2012.

Annex

In this Annex we clarify some key points raised in the Paper, with cross references to where we have addressed particular issues in previous submissions or evidence. We do not attempt to respond exhaustively to every comment made in the Paper and so we should not be taken to accept those points not addressed below.

1.1 **Paragraph 13:** The CC states that the respondents to Oxera's survey overlapped to some extent with the CC's investor questionnaire. It should be noted that there is likely to be a further overlap with those involved in the investor hearing. The CC should take care not to place too much weight on what is a minority view.

1.2 **Paragraph 16:** Hermes has indicated that "*audit quality is currently invisible to shareholders and that better disclosure of what the auditor had done and the issues that had been examined would make the quality more apparent*". However, there are a number of visible measures of audit quality, including:

(a) The reports of the Audit Inspection Unit, the FRRP and the US PCAOB;[24]

(b) The detail contained in each of the audit firms' Transparency Reports, including in respect of the quality review procedures followed and the scores achieved;[25] and

(c) The outreach initiatives that we, and other audit firms, engage in to provide the investor community with information about how to assess audit quality.[26]

1.3 As to the suggestion that for investors to assess quality, it is necessary for there to be better disclosure of what the auditor has done and the issues that have been examined, there is a tension between full transparency and reaching judgements as to the appropriate accounting treatment of issues in a confidential environment that is conducive to an open debate. In our experience, investors recognise, as we have previously stated in our Response to Certain Third Parties' Submissions (paragraph 2.8), that "*[w]idespread disclosure of information relating to the detail of the audit process would not only be wholly impractical, but would also undermine commercial confidentiality and compromise the integrity of the audit process by making it very difficult for auditors to encourage management to have frank and open discussions with them about issues of potential uncertainty or concern. The maintenance of investor confidence is a key reason why disclosures relating to the audit process are treated with great sensitivity by companies*."[27]

1.4 **Paragraph 26(b):** We agree with the investor's view that the statutory audit process and the opinion that the financial statements provide a "true and fair" view is about "*more than the*

---

[24] As explained in paragraphs 3.45 to 3.54, and 6.49 to 6.52 of our Initial Submission.

[25] We explain the internal quality assessments that we complete in paragraphs 6.53 to 6.58 of our Initial Submission, with the KPI scores made public in the Transparency Report.

[26] Including our "Auditor meets" series of meetings, referred to above.

[27] See Audit today and tomorrow (page 14). One of the mainstream investors who participated in the study highlighted the tension between quality and transparency: "*If you don't have privacy, you don't have honesty. And if you don't have honesty, nothing properly gets done.*"

numbers". However, it is important to appreciate that the audit process is not designed to enable the auditor to provide assurance on whether the "*controls were working properly, proper risk management*" as to provide such assurance would be an expansion of the scope of the statutory audit.

1.5 **Paragraph 29:** The CC states that the default view is that "*bigger firms were safer, but that this was not borne out by the evidence*." In fact, the evidence summarised below shows that the four largest audit firms offer a high quality audit. Our record, and that of the other largest firms, demonstrates that we offer a "safer" audit in respect of large companies:[28]

(a) Financial Reporting Review Panel (FRRP) press releases are issued where, following FRRP review, a company agrees to revise its accounts or take other corrective action. Only two FRRP press releases since 2005 related to PwC clients, of which only one - that of [✂] - related to the financial statements. Such FRRP releases are rare, with 17 since 2005, only two of which related to the FTSE 350.

(b) Accounting restatements resulting from companies issuing poor quality financial statements are rare, and it is extremely unusual for them to have material consequences. Apart from the [✂] case referred to above, no restatements in the last six years relating to PwC FTSE 350 clients had a material effect on reported profit or net assets or arose from regulatory inspections or processes.[29]

(c) We face a very low level of litigation and regulator complaints in relation to our audit work - something which is inconsistent with allegations of frequent low quality audits.[30]

1.6 **Paragraph 39(a):** The CC notes that "*[m]ost people would not differentiate between the quality of the audit from any of the Big 4 firms*". While it may be right that investors do not distinguish between the quality of each of the four largest firms, we strive to differentiate our audit from that of our competitors, as demonstrated for example by our Audit Transformation Programme.[31]

1.7 **Paragraph 62:** The CC sets out a list of the possible additional information which could be provided in the audit report. However, paragraphs 62(a), (b), (d) and (e) are matters on which the company and not the auditors should report. Similarly, in **paragraph 70**, the reference to an explanation of the differences between cash flow and income statements is also a matter for the company/audit committee to report on rather than being appropriate for auditor reporting. Moreover, the reference to risk statements in **paragraph 71** should be clarified as these are not part of the financial statements but disclosures included in a company's directors report / business review or in a prospectus filing.

---

28 See paragraph 3.6 of our Response to Certain Third Parties' Submissions. See also section 3D (and paragraph 3.53 in particular) of our Initial Submission where we describe how external observers, the AIU and the FRRP, and large companies themselves have viewed the capabilities of the mid-tier firms and have recognised that PwC and the three other large firms have invested over time to develop the attributes required for a safe and high quality audit.

29 See our MFQ Response (response 62).

30 See our MFQ Response (responses 44 to 46).

31 See Annex 6 of our Initial Submission.