

## PwC Response to certain Third Party Submissions

### 1 Introduction

- 1.1 This paper addresses certain important and material matters contained in some of the third party submissions and hearing summaries which are now in the public domain. Many of these matters were considered in our Submission of 12 January 2012 (our **Submission**) and our subsequent responses to questionnaires. However, before working papers are produced, we seek to set the record straight in respect of numerous inaccuracies and misconceptions, and to address where certain comments lack the appropriate perspective or evidence, so as to ensure that the Competition Commission (**CC**) does not proceed in this investigation on what we would consider to be an incorrect premise.
- 1.2 There are two sets of comments that we address in this paper:<sup>1</sup>
- (a) those made by certain shareholders and groups of shareholders which seek to link concerns they have about the regulatory framework for corporate governance to a lack of competition or quality in audits and the extent of innovation;<sup>2</sup> and
  - (b) those made by mid-tier audit firms and others which acknowledge that the large audit firms have a superior market reputation for quality and trust in conducting large company audits, but suggest that those responsible for acquiring audit services and other stakeholders are operating under a systemic misconception and that this superior reputation is not deserved.<sup>3</sup>
- 1.3 In considering these comments, it is important to recognise that the views of shareholders are not homogeneous. In our experience there are distinct differences in perspective between various groups of investors or investor representatives.<sup>4</sup> For example, representatives of investors who have more of a corporate governance responsibility in their organisations may have a different focus and be less exposed to the value of the audit process than those who have day-to-day investment management and trading responsibilities and focus on value aspects.<sup>5</sup> We note that the participants at the CC's Investors' Hearing - the Association of British Insurers (ABI), the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF) - are all trade bodies and not the mainstream investment professionals who actually rely on auditors' work in making investment decisions. Where we comment in this paper on the views of investors we are addressing only those

---

<sup>1</sup> We do not purport to address all third party comments with which we disagree in this paper.

<sup>2</sup> See the Summary of hearing with institutional investors held on 16 April 2012 (**Summary of Investor Hearing**) (paragraph 21); Submission of Universities Superannuation Scheme Limited dated 9 May 2012 (**USS Submission**) (pages 3 and 8); Hermes' response to the Issues Statement, dated 27 January 2012 (**Hermes Response to Issues Statement**) (page 2); and Summary of hearing with Hermes Equity Ownership Management, dated 15 March 2012 (**Summary of Hermes Hearing**) (pages 2 and 3).

<sup>3</sup> See Grant Thornton Response to the Issues Statement, dated 12 January 2012 (**GT Response to Issues Statement**) (paragraph 1.4); Response of BDO LLP to the Issues Statement, dated 25 January 2012 (**BDO Response to Issues Statement**), (paragraphs 2.2 to 2.3); Mazars LLP Submission, dated 11 November 2011 (**Mazars Submission**) (paragraph 12); and Group A Submission, dated 27 March 2012 (**Group A Submission**) (paragraph 6).

<sup>4</sup> See our survey "Audit today and tomorrow", 2011 [3<].

<sup>5</sup> The Audit today and tomorrow survey finds that overall, investment professionals place relatively low importance on receiving more information about going concern and there is relatively high satisfaction with the adequacy of information currently received about going concern. However, corporate governance specialists place high importance on the need for additional going concern information, and rate the adequacy of current disclosure poorly. Mainstream analysts do not consider the area unimportant, but feel there is access to significant information from management and importantly other sources (see page 15). See also the distinctions between investment professionals' and corporate governance specialists' preferences for information disclosure (page 21).

statements that have been made to the CC - we recognise that there are a variety of different views and perspectives among the investor community as a whole.

1.4 The third party comments which give us cause for concern consist in the main of a series of assertions with little or no evidence to back them up. Where evidence is provided it does not, when subjected to scrutiny, support the allegation in question. This paper responds to these assertions by making the following points:

(a) **Information asymmetries do not reduce audit quality (Section 2):**

- (i) The fact that investors are necessarily one step removed from the audit process and do not have full visibility of the detailed audit process should not detract from the reality that, in a competitive market, high quality audits are delivered to large companies.
- (ii) There are effective safeguards to ensure the scrutiny of the audit process through existing regulatory and structural arrangements. In particular, non-executives and audit committees act as proxies for shareholders, thereby ensuring that any information asymmetries between the various stakeholders in the audit process do not restrict the effectiveness of competition.
- (iii) The evidence shows that an effective relationship between the audit firm and management drives high quality and efficient audits.
- (iv) Notwithstanding this, we understand and sympathise with investors' desire for greater transparency of the audit process. Although the form and content of the auditor's report itself is prescribed by regulation, we have been and remain actively engaged in promoting increased transparency of the audit process within companies' annual reports.

(b) **Audit quality and innovation are high (Section 3):**

- (i) There is compelling evidence to demonstrate that the quality of large company audits is high, and there is no basis to suggest that higher and sustained quality would be achieved if the structure of the market were different. Listed companies are subject to relentless scrutiny by analysts and other experts who are quick to identify and publicise any failings.
- (ii) We constantly innovate in the following respects:
  - (A) to help companies improve the relevance and reliability of their corporate reporting;
  - (B) to enhance the quality and efficiency of our audit process, through the delivery of our Audit Transformation Programme; and
  - (C) to differentiate our audit service within the boundaries of the regulatory model, including by adding value during the audit process so as to improve company performance to the benefit of shareholders.

We recognise that these innovations may not be directly visible to shareholders, with whom we do not interact directly in the delivery of the audit other than through the AGM, but this does not detract from their value.

- (c) **Auditor reputation reflects the reality of customer experience (Section 4):**
- (i) The reputation of the large audit firms for quality reflects reality; it is a consequence of the investments they have made and the experience they have of carrying out large company audits. The purchasing decisions of those responsible for acquiring audit services for large companies are informed by market experience and their personal experience of using these and other firms and by recognition of the large audit firms' specific characteristics compared to other audit firms. This gives rise to efficient outcomes, consistent with the relevant economic literature.
  - (ii) The arguments advanced by certain mid-tier firms to suggest that the reputation of the large audit firms is in some way undeserved and/or is relied on inappropriately by large companies when selecting an audit firm do not stand up to scrutiny. Likewise, there is no evidence to suggest that our alumni favour us (or other large audit firms) inappropriately when, as their careers evolve over many years, they later work for large companies or regulators.

## 2 Information asymmetries do not adversely affect competition and audit quality

2.1 Much of the concern expressed by certain investor representatives around audit quality and competition appears to stem from what they see as a lack of auditor accountability arising because investors - as shareholders - have limited visibility as to the detail of the work the auditor undertakes. We explain in section 3 that there is no basis to conclude that audit quality is low, and we are concerned that unfounded concerns relating to audit competition and quality should not be conflated with legitimate concerns around improving corporate and audit reporting to shareholders.

2.2 In this section we explain:

- (a) the relationship between the binary auditor's report and the complex process leading to the production of the auditor's report;
- (b) the effective role of the audit committee as a proxy for more detailed direct shareholder oversight of the audit process;
- (c) the importance of the relationship between the auditors and company management and how this gives rise to good quality and independent audits; and
- (d) the continuing efforts by us and others to improve audit reporting.

### ***The auditor's report and the process leading to the auditor's report***

2.3 The output of the auditor's work which is most visible to shareholders is the auditor's report. The binary "clean" or "modified" nature of the auditor's report ensures it provides a reference point as to whether the company's financial statements offer a "true and fair" view. Such a report has real value in giving a clear message on the reliability of the financial statement to shareholders and others - there is no need to "read between the lines" to interpret what the report really means. As set out in Box 1 below, the current regulatory regime (in particular ISA (UK&I) 700) places clear limitations on the level of disclosure and detail the auditor may include in the auditor's report.

2.4 The simplicity of the auditor's report does not reflect the detail and value of the underlying audit process. It is the audit process that gives continual assurance that financial statements prepared by the company, which can run to well in excess of a hundred pages, give a true and fair view. Without this underlying annual assurance on the accuracy of company data, the investor community would not have the confidence it does to react to the more immediate flows of financial information released by companies.

2.5 It is this relationship between the apparent simplicity of the auditor's report (which is visible to shareholders) and the detailed and challenging process that goes into producing the report (which is not so transparent to shareholders as a group) that may account for some of the apparent inconsistencies in the views expressed in the Summary of the Investor Hearing. On the one hand it is said that the audit represents "*minimum perceived value*",<sup>6</sup> gives only a "*basic level of assurance over historical information*", it is "*too little too late*"<sup>7</sup> and is "*uninformative*".<sup>8</sup> On the other hand, the auditor's

---

<sup>6</sup> Summary of Investor Hearing (paragraph 2).

<sup>7</sup> Summary of Investor Hearing (paragraph 4).

<sup>8</sup> Summary of Investor Hearing (paragraph 5).

report is "a very important document to the markets", a clean opinion provides "reasonable assurance...that [the audited firm] would continue as a going concern for at least the next 12 months",<sup>9</sup> and the "audit process...led to more accurate reporting".<sup>10</sup> The reality is that the "reasonable assurance" which the investor representatives acknowledge they receive from the binary audit opinion is exactly what makes "considerable time" spent by analysts reviewing the numbers worthwhile.<sup>11</sup>

- 2.6 There are valid reasons why shareholders necessarily have limited visibility as to the auditor's work, and we explain below that there are safeguards in place to scrutinise the audit process (primarily through the audit committee) as well as constant efforts to improve audit reporting (with which PwC is fully engaged). Shareholder visibility does not adversely affect the competitive environment in which we operate, or the incentives we have to provide high quality, good value audit services.

#### Box 1 - ISA (UK&I) 700

The form of the auditor's report is prescribed by the Auditing Practices Board's (APB) ISA (UK&I) 700, based on the international ISA 700. ISA (UK&I) 700 states that the purpose of the auditor's report is to confirm whether or not the company's financial statements offer a "true and fair view". If they do not, this will result in a modified opinion. The auditor's ability to include additional commentary is very limited, as explained below. ISA (UK&I) 700 prescribes in specific terms the format, content and scope of the report. The example auditor's reports provided at the end of ISA (UK&I) 700 are highly instructive in illustrating the format and limited detail to be contained in the auditor's report.<sup>12</sup>

Hermes suggests<sup>13</sup> that ISA (UK&I) 700 had been written "with the express aim of encouraging more flexible and informative auditor reporting, but sadly this opportunity is not being seized." We do not agree with this. The APB press release that accompanied the issue of ISA (UK&I) 700 in 2009<sup>14</sup> states that the revised regulation had two aims:

- (a) A "first phase" to introduce more concise auditor's reports (including by allowing audit firms the option of removing "boiler plate" wording and instead referring the reader to the APB's website); and
- (b) A "second phase" to "undertake research to better understand what could be done to make auditor's reports more informative." The APB recognised in this context that changes to the form and content of the auditor's report would need to be coordinated internationally.

At the same time, the APB adopted the international ISA 705 (on Modified Opinions) and ISA 706 (on Emphasis of Matter and Other Matter paragraphs) and stated that it would monitor whether the changes made to ISA 706 would lead to auditors providing additional comment in the auditor's

<sup>9</sup> Summary of Investor Hearing (paragraph 5).

<sup>10</sup> Summary of Investor Hearing (paragraph 2).

<sup>11</sup> See Summary of Investor Hearing (paragraphs 2, 5 and 9).

<sup>12</sup> See pages 23-31 at [http://www.frc.org.uk/getattachment/60dc9adb-1e00-4dec-9a1c-788fd7fe1fc1/700-\(Revised\)-The-Auditor-s-Report-on-Financial-Statements.aspx](http://www.frc.org.uk/getattachment/60dc9adb-1e00-4dec-9a1c-788fd7fe1fc1/700-(Revised)-The-Auditor-s-Report-on-Financial-Statements.aspx). (The example auditor's reports are provided as Exhibit 2).

<sup>13</sup> Hermes Response to the Issues Statement (page 2).

<sup>14</sup> See APB Press Release dated 26 March 2009 at [http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2009/March/APB-Issues-a-revision-of-ISA-\(UK-and-Ireland\)-700.aspx](http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2009/March/APB-Issues-a-revision-of-ISA-(UK-and-Ireland)-700.aspx).

report to highlight matters that they regard as relevant to a proper understanding of their work.

Contrary to the Hermes suggestion, the requirements and application material in ISA 706 did not promote widespread use of Other Matter paragraphs to provide commentary on the audit, but only when, in the auditor's judgement, it was necessary to disclose certain factual information.<sup>15</sup>

Equally, Emphasis of Matter paragraphs (under ISA 706) are currently required to be used rarely, with ISA 706 explicitly recognising that "*wide-spread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication*".<sup>16</sup>

Consequently, auditors have not felt able to include further information on their own initiative in the manner that Hermes suggests is possible because:

- including narrative commentary is counter to the conceptual underpinning of today's standardised auditor's report model;
- as illustrated above, a reading of the relevant guidance does not give any clear direction or instructions to audit firms to include in their auditor's reports more detail on their views regarding the entity's financial reporting, or the work performed in carrying out the audit, and indeed the guidance discourages it; and
- unilaterally departing from the standardised report used by all auditors risks the additional commentary being misinterpreted by markets and media, with the possibility of negatively influencing investor's decisions.

Consideration of changes to the scope of auditor reporting would also need to have regard to the question of auditor liability reform.

### ***Effective safeguards to ensure scrutiny of the audit process: The role of the audit committee***

2.7 The purpose of the statutory audit is to provide assurance to shareholders that the directors have provided "true and fair" financial statements in accordance with their statutory duty.<sup>17</sup> This is because shareholders cannot assure themselves of this, due to their lack of direct access to the information available to management (the "information asymmetry" referred to in the Issues Statement). Audit

<sup>15</sup> Because the APB adopted all the international ISA application material in relation to ISA 706, the implication was that Other Matter paragraphs would not be widely used other than for disclosure of factual information required in certain circumstances. This is reinforced by the examples given of such paragraphs which are all factual statements, i.e. referring to the fact an auditor has reported on more than one set of financial statements for the same entity, restricting the distribution or use of the auditor's report or setting out the circumstances when the auditor would have resigned due to a limitation on scope. None of these examples suggest a use of Other Matter paragraphs to detail the auditor's views or provide detail on how the audit was conducted. The APB's Compendium of Illustrative Reports (2010/2 Revised, dated 20 March 2012, paragraphs 33 and 34) also refers to other examples of Other Matter paragraphs - but again these are limited to factual information. See <http://www.frc.org.uk/getattachment/fc7312df-3256-46d4-ade4-4f72405e640b/Bulletin-2010-2-Compendium-of-Illustrative-Auditor-s-Reports-on-United-Kingdom-Private-Sector-Financial-Statements-for-periods-ended-on-or-after-15-December-2010.aspx>.

<sup>16</sup> While there is active consideration of greater use of Emphasis of Matter paragraphs to draw attention to areas of, for example, significant accounting judgement or measurement uncertainty in the financial statements, the current ISA 706 is explicit (paragraph A2) on their use being limited. Furthermore, the standard today restricts the Emphasis of Matter to a clear reference to where matters are described in the financial statements, effectively prohibiting any additional commentary on those matters.

<sup>17</sup> Section 393, Companies Act 2006.

firms perform this function and, as described below, they do so effectively. Notwithstanding that both directors and auditors have every incentive to ensure a robust review of the financial statements, shareholders, quite rightly, require confidence that the audit firms themselves are properly subject to scrutiny and are incentivised to deliver efficient services. Regulatory bodies and market-related mechanisms - in the form of non-executives and audit committees - exist to give shareholders this assurance.

- 2.8 There is a continuing debate (which we have encouraged, as explained below) as to how much information the company, the audit committee, and the auditor should provide to the shareholders. While we strongly believe that regulatory changes should facilitate improved audit reporting,<sup>18</sup> it is wholly unrealistic to suggest (as certain investor representatives appear to imply) that the competitive process cannot operate effectively unless all shareholders individually and collectively (and therefore the public at large) have access to the details of internal discussions and debates between the auditors and company management.<sup>19</sup> This suggestion is at odds with the UK corporate governance model which recognises that individual shareholders cannot be involved in the day-to-day supervision of management and delegates this task to non-executives (including audit committees) to act on behalf of shareholders. Widespread 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.<sup>20</sup>
- 2.9 Beyond the confines of the auditor's report (and the increasing efforts which company boards are making - often encouraged by auditors, as explained below - to disclose more information in the audit committee section of Annual Reports),<sup>21</sup> the opportunities for auditors to engage directly with individual shareholders outside the AGM (where there is an opportunity for shareholders to ask questions about the audit)<sup>22</sup> are restricted due to the risk of giving privileged access to confidential information (i.e. potentially facilitating insider dealing). There is also the practical issue of the fact that shareholdings in large companies change constantly, with many shareholders frequently owning shares for only a day or less.
- 2.10 The obvious and necessary limitations on the scope for extensive direct dialogue between shareholders and auditors are in part the reason for the existence of the extensive audit regulatory and inspection regime which provides shareholders with information to help them make judgements on auditor performance. However, the primary mechanism for ensuring that audit firms are responsive to market pressures and the demands of their clients is through the oversight and supervision

---

<sup>18</sup> Our response to the International Auditing and Assurance Standards Board (IAASB)'s 2011 consultation on audit reporting concluded: *"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).

<sup>19</sup> USS Submission (section 3).

<sup>20</sup> 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."*

<sup>21</sup> See Box 1 on the content of the auditor's report and Box 3 on our efforts to improve audit and corporate reporting.

<sup>22</sup> 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 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.

exercised by the board and the audit committee. It is the role of the audit committee (as a body of the board) to oversee the audit process and receive and assess the full range of relevant information on behalf of shareholders.<sup>23</sup> Audit committees are required to have the necessary expertise to do this, and to engage with the auditors and management throughout the various stages of the audit process to ensure - and report on - auditor effectiveness. In our experience, audit committees of large companies take their responsibilities in this respect seriously and perform their role to a high standard (see Box 2 below).<sup>24</sup>

- 2.11 If shareholders are dissatisfied with the performance of the audit committee and board in this regard they have the same redress as they do in respect of any other concerns about corporate governance failure - that is to replace the relevant individuals. Shareholders' ability to challenge board proposals has been demonstrated recently in relation to executive pay,<sup>25</sup> yet our experience suggests investors seldom raise issues relating to the auditor as a concern, at AGMs or in the regular meetings with the senior independent directors.<sup>26</sup> The fact that such issues are rarely raised suggests that, when it comes to deciding whether there is a basis to take positive action, shareholders have fewer concerns in this regard than are suggested in some of the representations that have been made to the CC.

#### **Box 2 - Audit committees are effective**

In our experience companies and their management take their governance responsibilities very seriously and in our Submission we evidenced the calibre and experience of audit committee members and finance directors.<sup>27</sup> We believe audit committees contribute positively to relevant and reliable corporate reporting and auditing and we reject the concerns expressed by some investors that they are ineffective.<sup>28</sup> There are numerous ways in which audit committees are active in challenging management and/or auditor positions. Examples of audit committees "showing teeth" in fulfilling their duties include:

- supporting auditors' suggestions that adjustments be made to draft results prior to publication or that further enquiries be made into allegations of fraud;
- ensuring that alternative accounting treatments receive due consideration;
- requesting enhanced analysis, evidence or action on going concern or impairment issues;
- raising questions from their interaction with the business, for example from visits to overseas operations or from their experience at other companies;

<sup>23</sup> As is codified in section C3 of the Combined Code, it is the role of the audit committee to represent the interests of shareholders through direct interaction with, and supervision of the auditors, and interaction with management. FTSE 350 companies are required to appoint an audit committee with three members at least one of whom must have "*recent and relevant financial experience*". Further, ISA 260 "Communications with those charged with governance" also sets out the auditor's responsibilities in relation to the Audit Committee and provides (at A7) that the auditors should be invited to regularly attend meetings of the audit committee; the chair of the audit committee and, when relevant, the other members of the audit committee should liaise with the auditor periodically; and that the audit committee should meet the auditor without management present at least annually. See also Annex 8 to our Submission in relation to the experience of audit committee members.

<sup>24</sup> See our Submission (paragraphs 5.5 to 5.13 and Annex 8). We note the AIU 2012 Report dated 13 June 2012, provided at <http://www.frc.org.uk/getattachment/98e3e7dd-cdbe-4e45-9078-14e07bf0d7d8/Audit-Quality-Inspections-Annual-Report-2011-12.aspx> (AIU 2012 Report) for the first time contains specific "Key messages to audit committees", recognising the importance of their role in ensuring audit quality.

<sup>25</sup> [an example of shareholder activity in relation to executive pay].

<sup>26</sup> As they are entitled to do - see in particular paragraphs A.4.1 and E.1.1 of the Corporate Governance Code at <http://www.frc.org.uk/getattachment/b0832de2-5c94-48c0-b771-ebb249fe1fec/The-UK-Corporate-Governance-Code.aspx>.

<sup>27</sup> See Annex 8 to our Submission.

<sup>28</sup> This is implicit in the assertion that auditors are unaccountable as suggested in the USS Submission (page 6).

- pushing for improvement in financial controls or changes in finance staff;
- ensuring accounts disclosures are comprehensive;
- making an appropriate linkage between accounting issues and judgements and management bonus considerations; and
- ensuring a cost effective audit service is received by identifying and following up service quality issues, challenging audit fees and ensuring appropriate non-audit service policies.

### ***The relationship between the audit firm and company management***

- 2.12 For auditors to undertake their task of closely scrutinising the underlying reality of companies' financial data they must have an effective working relationship with management in circumstances where the auditor is: (i) able to efficiently access and understand the relevant financial information; and (ii) not afraid to question management views in order to resolve concerns in the draft financial statements prior to presentation to the audit committee.<sup>29</sup> The experienced auditor will identify likely reporting and audit issues early in his or her work, evaluate the audit evidence and consider alternative outcomes on issues as they emerge, discussing relevant aspects with management and the audit committee as the audit proceeds to ensure the company's accounts are "true and fair " and compliant with regulation.
- 2.13 This unseen work of understanding the company's business, checking and influencing its accounts, and exercising professional scepticism in relation to findings is where the vast majority of an auditor's work is done and where the value of the audit process lies. When we asked our FTSE 350 audit partners, they reported that in the last five years the large majority (77 per cent) of audits of large companies have involved "*difficult or stressful*" conversations with management, and that these conversations almost always led to a change in management's approach to an accounting, disclosure or control issue (96 per cent).<sup>30</sup> Such difficult or stressful conversations only capture a small proportion of the auditor's influence, as typically auditor concerns will be resolved without need for confrontational discussion.
- 2.14 In all but the most unusual circumstances management have every incentive to ensure an effective audit, as this will facilitate their legal duty to provide "true and fair" financial statements, but also be likely to lead to improved company performance, upon which their personal performance will be judged. Auditors themselves have every incentive to provide robust and independent audit opinions as their wider market reputations over time - and thus their ability to retain and win audit clients - depend on them doing so.
- 2.15 Available evidence shows that the relevant stakeholders who are closely involved believe the audit process is effective:

---

<sup>29</sup> Hermes has highlighted a "*general misapprehension*" as to who the auditor's client is (Hermes Response to Issues Statement (page 1)) - the shareholders or the company - but there is no evidence provided other than the fact it is not unusual to refer to the company as "client" - this is no more than a form of shorthand which in no way indicates a substantive misunderstanding as to where the auditor's responsibilities lie.

<sup>30</sup> We asked the audit partners of 106 FTSE 350 companies whether they had conversations they would characterise as particularly "*difficult*" or "*stressful*" with management or those charged with governance in the last five years: of the 96 responses received, such discussions were reported in relation to 77 per cent of companies, with 96 per cent of such conversations resulting in management changing its approach to an accounting, disclosure, or control issue.

- (a) The value of the audit process conducted by the large firms has been recognised by the Hundred Group, as representatives of large company management;<sup>31</sup> and
- (b) Auditor effectiveness reports completed by audit committees recognise the effectiveness of the process and the independence of auditors.<sup>32</sup>

2.16 In this context, certain submissions to the CC suggesting an inability of shareholders to prevent auditor appointments or of auditor acceptance of inappropriate accounting by a company are inaccurate. In respect of the two audits referred to involving PwC:

- (a) The highlighting of TUI by the investor representatives misses the obvious point that this was an example of an auditor appointment being supported by the majority shareholder;<sup>33</sup> and
- (b) The allegations made by USS in relation to Premier Foods mischaracterise standard accounting practices.<sup>34</sup> The implication that in our audit of Premier Foods we accepted an inappropriate accounting treatment by the company of certain non-audit fees is incorrect. The company's accounting treatment for capitalisation of the costs in question was consistent with the company's stated accounting policies which were mandated by the relevant accounting standard. The treatment was consistent with the accounting for costs of a similar nature incurred by Premier Foods from other suppliers. The disclosure of the treatment in the auditor remuneration note was clear and fully consistent with all requirements.

#### **Continuing improvements in audit reporting**

2.17 Investor representatives have been forthright in their submissions that they would like more access to information in the auditor's report,<sup>35</sup> 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,<sup>36</sup> 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.<sup>37</sup>

---

<sup>31</sup> See the Hundred Group Submission to the CC dated 16 April 2012 (**Hundred Group Submission**) (page 2).

<sup>32</sup> We provided examples of auditor effectiveness reports for [redacted], [redacted] and [redacted] to the CC as Exhibits [redacted] to our response to the Market and Financial Questionnaire dated 24 February 2012 (**MFQ Response**) - these reports are completed every year by FTSE 350 companies and considered by audit committees in accordance with the Code. Audit committees have considerably greater flexibility to report on the detail of the audit process than the auditors, both to the board and to shareholders through the annual report. We provide as Exhibit 3 the [redacted], the report notes the following:

(a) on robustness of the audit: "PwC have the courage to challenge accounting treatments and are willing to spend time resolving issues. With regards to potential conflicts of interest, they have a good feel for where the boundaries lie."

(b) on industry expertise: "PwC are considered seasoned industry experts with integrity and good judgement. The audit team has provided robust challenge as well as a fair and appropriately pragmatic approach."

(c) the audit team's independence was one of its greatest strengths in the eyes of the audit committee - it was awarded scores for "Independence" of 9.2 and 9.4 in 2011 and 2010 respectively, the highest scores received across any of the 20 categories which were measured.

<sup>33</sup> See Summary of Investor Hearing (paragraph 22).

<sup>34</sup> See USS Submission (page 4).

<sup>35</sup> Summary of Investor Hearing (paragraph 21), USS Submission (page 9).

<sup>36</sup> See PwC Chairman Ian Powell's 2010 speech "Building Public Trust" (**BPT Speech**), provided as Exhibit 4.

<sup>37</sup> Hermes Response to Issues Statement (page 2).

- 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 above). 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.<sup>38</sup> 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<sup>39</sup> and this is something that we believe should be actively explored.<sup>40</sup>
- 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*".<sup>41</sup> 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.<sup>42</sup> 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 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.

---

<sup>38</sup> See for instance the PwC response to the 2011 IAASB consultation on the future of auditor reporting, referred to at footnote 18 above. PwC will also comment on the Invitation to Comment recently released by the IAASB on 'Improving the auditor's report', which sets out the IAASB's proposals for change to the auditor's report following on from the 2011 consultation process, available at [http://www.ifac.org/sites/default/files/publications/files/Auditor\\_Reporting\\_Invitation\\_to\\_Comment-final\\_0.pdf](http://www.ifac.org/sites/default/files/publications/files/Auditor_Reporting_Invitation_to_Comment-final_0.pdf).

<sup>39</sup> See [http://www.frc.org.uk/getattachment/cf1f2c07-b64e-40bb-bcbb-51f639760978/Consultation-Paper-Proposed-Revisions-to-International-Standards-on-Auditing-\(UK-and-Ireland\).aspx](http://www.frc.org.uk/getattachment/cf1f2c07-b64e-40bb-bcbb-51f639760978/Consultation-Paper-Proposed-Revisions-to-International-Standards-on-Auditing-(UK-and-Ireland).aspx), in particular paragraphs 6(c)(ii), 22 and a20(b).

<sup>40</sup> 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/FRC-Board/Effective-Company-Stewardship-Enhancing-Corporate/Responses-to-Effective-Company-Stewardship-Enhanci/PricewaterhouseCoopers-LLP.aspx>.

<sup>41</sup> See Summary of Investor Hearing (paragraph 6). See also Box 1 above.

<sup>42</sup> See the Paper entitled "The Progressive Agenda - Increasing Corporate Transparency in the Audit Committee Report", dated 7 June 2011, provided as Exhibit 5 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.

### 3 Audit quality and innovation are high

- 3.1 In this section we respond to the evidence put forward by third parties to support their suggestions of low audit quality. These suggestions appear to rest on two premises:
- (a) first, that good quality audits would have anticipated the financial crisis of 2008; and
  - (b) second, that the audit regulation and inspection regime demonstrates that audit quality is unsatisfactory.
- 3.2 Certain third parties have also suggested that the large audit firms have failed to innovate in the delivery of the audit service. We explain below that the evidence shows that the level of quality and innovation in the large company audit process is high.

#### ***The financial crisis***

- 3.3 While the financial crisis has lessons for all involved,<sup>43</sup> including audit firms, it is incorrect to draw the conclusion that the crisis demonstrated a failure of the competitive process for audit services.<sup>44</sup> There is no evidence that the financial crisis showed that there was audit failure or that audits were of low quality, and there is nothing to link the crisis to ineffective audit competition. We are actively engaged in taking steps to improve the audit framework to try and respond to the lessons learnt from the financial crisis,<sup>45</sup> but we do not consider that any change to the competitive process would have led to any bank receiving a modified auditor's report prior to the financial crisis, as was suggested by USS in its submission to the CC.<sup>46</sup> In this respect, we note the mid-tier firms acknowledge they lack the necessary expertise to audit the largest financial institutions.<sup>47</sup>
- 3.4 As set out in Box 1 above, there are clear regulatory limitations on what auditor's reports can include. With respect to "going concern" status, if the auditor concludes that material uncertainty exists regarding the entity's ability to continue as a going concern, the auditor may only include an Emphasis of Matter paragraph drawing attention to the entity's disclosure of the material uncertainty, or modify the audit opinion if necessary disclosure is inadequate (ISA (UK&I) 570). The auditor's conclusion regarding the "going concern" status of a company is based upon an evaluation of identified events or conditions, taking into account their potential impact and likelihood of occurrence. Auditors had no more visibility of bank solvency pre-crisis than the banks, governments, regulators or the wider investor community, and no reason to believe a liquidity freeze was more likely than was generally perceived at the time. It would not have been tenable for auditors to qualify audit opinions on banks on the basis of a potential credit crisis when this was generally viewed at the time as, at most, a remote possibility. USS's suggestion that auditors should have identified solvency concerns at banks

---

<sup>43</sup> See paragraph 1.24 of our Submission where we noted that "*What occurred in 2008 was unprecedented and cannot be allowed to happen again. There is an obligation on us, and all those involved in managing large companies and monitoring or reporting on company performance, to consider changes that might minimise the risks of such events occurring again.*"

<sup>44</sup> See House of Commons Treasury Committee Report into the collapse of Northern Rock and the banking crisis that confirmed that auditors did not fail to fulfil duties prior to the financial crisis (as cited in our Submission (paragraphs 1.22 and 2.56)). Relevant regulators such as the FRC and FSA have not sought to ascribe blame to auditors, and auditors have not faced litigation from banks or their shareholders in relation to these audits. We note the Accountancy and Actuarial Discipline Board recently closed its investigation of Ernst & Young in relation to its handling of Lehman Brothers' off balance sheet transactions in the run up to the financial crisis - see [http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/June/Lehman-Brothers-International-\(Europe\).aspx](http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/June/Lehman-Brothers-International-(Europe).aspx).

<sup>45</sup> See our Submission (paragraph 2.59) in relation to the five priority areas for reform we have identified.

<sup>46</sup> USS Submission (page 3).

<sup>47</sup> See GT Response to Issues Statement, (paragraph 1.8), BDO Response to Issues Statement, (paragraph 2.3).

ignores the fact that these solvency concerns only arose because of the liquidity freeze which gave rise to a sudden increase in the cost of borrowing and severely restricted its availability.

- 3.5 The financial crisis was a consequence of a very distinct and largely unanticipated set of highly unusual circumstances affecting a single industry sector, and it is inappropriate to seek to draw lessons about the competition in the audit market as a whole from this. Financial institutions represent a relatively small, but highly complex, part of the overall large company audit market. This may be contrasted with the position of the financial services regulators where any concern about performance in the crisis goes to the heart of their market responsibilities.<sup>48</sup> As has been noted, the vast majority of companies did not fail during the financial crisis and robust audits were a key contributor to that.<sup>49</sup>

#### ***Audit inspections and other quality indicators***

- 3.6 Just as it is inappropriate to consider the financial crisis as an indicator of poor audit quality, it would be wrong to take isolated examples of allegedly poor quality audits and use these to suggest that there is a broader market problem.<sup>50</sup> Large company audits involve the exercise of judgement in relation to often highly complex matters and, regrettable as it is, occasionally errors will be made. It follows that the benchmark for an effective audit system cannot be 100 per cent accurate in all cases. Indeed, attempting to achieve such accuracy would involve prohibitively high costs in checking what would amount to millions of transactions for large companies. The real question is whether there is broader systemic quality failure - the evidence shows this is not the case:

- (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 - [redacted] - 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 [redacted] 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.<sup>51</sup>
- (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.<sup>52</sup>

---

<sup>48</sup> For example, the FSA's inadequacies in financial services supervision have been demonstrated by the financial crisis - see for example the House of Commons Treasury Committee report: Banking Crisis: regulation and supervision, dated 21 July 2009 (page 3): "By any measure the FSA has failed dreadfully in its supervision of the banking sector".

<sup>49</sup> See the Hundred Group submission (page 1): "The vast majority of companies, both in the UK and in the rest of the EU remained strong during the recent financial crisis, and indeed weathered the very difficult economic conditions admirably. Inevitably certain sectors fared less well than others: However to predicate a significant and wide ranging reform on these isolated examples is to ignore the fact that in the vast majority of cases, the role and effectiveness of independent auditors has not been, and should not be, called into question." (Emphasis added). See also page 1 of the Insurance Europe submission to the European Commission: "[t]here is no evidence that audits of insurers have been inadequate or that auditor independence has been violated during the last financial crisis." at [http://www.insuranceeurope.eu/uploads/Modules/Publications/position\\_paper\\_on\\_the\\_audit\\_legislative\\_package.pdf](http://www.insuranceeurope.eu/uploads/Modules/Publications/position_paper_on_the_audit_legislative_package.pdf).

<sup>50</sup> USS Submission (page 4), BDO Response to Issues Statement (paragraphs 1.6.3(c) and 4.22(c) - (d).

<sup>51</sup> See MFQ Response (response 62).

<sup>52</sup> See MFQ Response (responses 44 to 46).

- 3.7 Audit Inspection Unit (AIU) reports have been cited by certain parties<sup>53</sup> as indicators of poor quality in respect of FTSE 350 audits – whereas, according to the AIU’s latest annual report, the vast majority of audits inspected are classified as of good or acceptable quality with further reductions in the proportion of audits requiring significant improvements.<sup>54</sup>
- (a) Given that the AIU’s objective is “*to monitor and promote improvements in the quality of auditing*”,<sup>55</sup> it is virtually impossible to receive a completely “clean” bill of health from the AIU stating no improvements are required – indeed no such grade exists in the AIU’s grading system. This is because in delivering complex professional services such as an audit there is always room to argue that improvements can be made. This does not mean that the competitive process has failed - indeed, our stated aim of seeking to improve quality continuously, and the considerable resources that we devote to this, reflect the competitive pressure we face.<sup>56</sup>
- (b) There are three grades used by the AIU for public reporting of which the top grade is “*good with limited improvements required*”, the middle grade is “*acceptable overall with improvements required*” and the bottom grade is “*significant improvements required*”. Only a very small number of FTSE 350 audits inspected by the AIU fall into the bottom category<sup>57</sup> (only four in the last two years). Of all companies reviewed by the AIU, the number of audits receiving this grade has declined over time.<sup>58</sup>
- (c) Moreover, the AIU acknowledges that - contrary to what is suggested by Grant Thornton and others<sup>59</sup> - its reports cannot be used to benchmark audit quality between firms: “*While our public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review which, in turn, reflects the firm’s client base.*”<sup>60</sup> (Emphasis added.)

---

<sup>53</sup> USS Submission (page 3), BDO Response to Issues Statement (paragraph 4.22(b)), Grant Thornton Response to Issues Statement (page 3), Written Evidence of Iain Richards to the House of Lords Select Committee, dated 11 January 2011 (paragraph 1.11).

<sup>54</sup> AIU 2012 Report (paragraph 1.3).

<sup>55</sup> AIU 2012 Report (Appendix A).

<sup>56</sup> For example, see the response of James Chalmers, our Head of Assurance, to the AIU 2012 Report: “*Quality is at the very heart of what we do: it is essential to our reputation, important to the work that we undertake for our clients and is a fundamental strategic objective for the firm. Such insights, observations and recommendations are an important contribution to helping us focus on and deliver continuous quality improvement.*” (<http://www.financialdirector.co.uk/aa/news/2185210/pwc-warned-improve-house-audit-training-frc>). See also our Submission (paragraph 2.39(d)(i)).

<sup>57</sup> As regards the status of an AIU “*significant improvements required*” grade, it is important to note that, because the AIU’s purpose is continuously to improve audit quality, its benchmark will endogenously rise and it will tend to focus on higher risk areas. This means that even where the AIU has found “*significant improvements required*” the quality of the audit itself may still have been sufficient for the auditor’s report to be reliable - as the AIU acknowledges, a “*significant improvement required*” grading “*does not necessarily imply that the financial statements were materially inaccurate or incomplete, or that an inappropriate audit opinion was issued.*” (AIU 2012 Report, page 7).

<sup>58</sup> AIU 2012 Report (page 8): “*The number of audits requiring significant improvements has continued to decline to less than 10% of the audits reviewed.*”

<sup>59</sup> GT Response to Issues Statement (paragraph 1.5(d)), Grant Thornton presentation, dated 14 February 2012 (slide 15), Kingston Smith Response to Issues Statement, dated 21 February 2012 (page 3). BDO Response to Issues Statement (paragraphs 1.6.3(b), 4.22(b)).

<sup>60</sup> AIU 2012 Report (page 19): “*An issue reported in relation to a particular firm may therefore apply equally to other firms without having arisen in the course of our inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the quality of each firm’s audit work.*”

- (d) The AIU selects higher risk audits for inspection based on a number of factors, including, but not limited to, industry sector, size, complexity and reputation. Audits exhibiting these characteristics inevitably involve greater complexity and judgement and therefore it is meaningless to extrapolate percentages of audits given a particular AIU grading to the market as a whole.<sup>61</sup> Given that the AIU selects higher risk audits for inspection, the proportion of FTSE 350 audits inspected and found to require significant improvement is likely to be (far) higher than the proportion of overall FTSE 350 audits that would receive that grade if they were all inspected. This effect is accentuated by the fact that, as part of an inspection, the AIU will assess the work performed in areas of higher risk in relation to the particular (high risk) audits selected for review.
- (e) In its 2012 report, the AIU has also highlighted concerns that pricing pressure on auditors could compromise professional scepticism.<sup>62</sup> We have provided examples of where we have ceased to act due to pressure to reduce fees inhibiting our ability to carry out what we believed to be the necessary scope of work,<sup>63</sup> and it is self-evident that larger audit firms are better able to resist such pressure from clients than smaller firms for whom the individual company will represent a larger proportion of overall revenues.<sup>64</sup>
- (f) As regards our own performance, the AIU acknowledges that, while there remain areas for improvement, “[PwC] places considerable emphasis on its overall system of quality control and has appropriate policies and procedures in place for its size and the nature of its client base in most areas that are subject to our review.” (Emphasis added).<sup>65</sup>
- 3.8 Finally, as explained in more detail in our Submission, our internal quality benchmarks such as Engagement Compliance Reviews and the Quality KPIs<sup>66</sup> are raised incrementally to ensure continuous improvements, and have nonetheless consistently resulted in quality scores of around 95 per cent. This is also inconsistent with any suggestions of low audit quality.

### **Auditor innovation**

- 3.9 Criticism about a lack of innovation by auditors<sup>67</sup> is misconceived. Competitive pressure has driven us to constantly innovate over many years, and this innovation continues through our initiatives:
- (a) to help companies improve the relevance and reliability of their corporate reporting;
- (b) to enhance the quality and efficiency of the audit process, which we are doing for example through the delivery of our Audit Transformation Programme; and

---

<sup>61</sup> AIU 2012 Report (page 16): “We have developed a risk model covering listed companies, including AIM, which we use to inform the selection of audits to be reviewed each year. The majority of audits selected for review were drawn from those identified as higher risk within this risk model.” (Emphasis added).

<sup>62</sup> AIU 2012 Report, (page 6).

<sup>63</sup> See our Submission (paragraph 7.41).

<sup>64</sup> See DeAngelo (1981), Auditor size and audit quality, Journal of Accounting and Economics, Vol. 3, No. 3: 183-199.

<sup>65</sup> See AIU Public Report on the 2011/12 inspection of PwC dated 15 June 2012, available at: <http://www.frc.org.uk/getattachment/c605e288-2ee8-4954-b3d0-920804f297ac/Public-Report-on-the-2011-12-inspection-of-PricewaterhouseCoopers-LLP.aspx> (page 4).

<sup>66</sup> Discussed in our Submission (paragraphs 6.53 to 6.58).

<sup>67</sup> USS Submission (page 3); GT Response to Issues Statement (paragraphs 3.2 to 3.4); BDO Response to Issues Statement (paragraph 4.1), Summary of BDO Hearing (**Summary of BDO Hearing**) (paragraph 33).

- (c) to 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.

*Improving the relevance and reliability of corporate reporting*

- 3.10 We have sought over many years to help companies improve corporate transparency and reporting. This is evident both from our engagement with the investment community, and how we have leveraged the insights gleaned from that engagement to encourage better reporting practice. The activity has involved an experienced audit partner and team being committed largely full time over the past decade at an approximate cost of £[><]. We set out in Box 3 further details of our efforts to improve corporate reporting.<sup>68</sup>

**Box 3 - Building public trust**

**(1) Engaging with investment professionals**

For over a decade,<sup>69</sup> we have been engaging with mainstream investors and analysts to understand whether the reporting and assurance models are meeting user needs.

Examples of our investment community engagement programme include:

- Our Building Public Trust initiative, which is in its tenth year, has as its objective the improvement of corporate reporting.<sup>70</sup>
- Formal surveys of investor views on audit and corporate reporting. (See for example the Audit today and tomorrow survey (Exhibit 1)).
- Facilitating numerous meetings of groups of investors, and between investors and other stakeholders (such as standard setters, regulators and corporate bodies) to discuss particular reporting issues. Over the past 12 months, we have facilitated approximately 60 meetings with groups of investors globally.
- An industry-based investor outreach programme – the Meet the Auditor initiative – that allows both investors and auditors to share their perspective on auditing and reporting issues in a given sector. Over the past nine months, 23 UK partners have met with over 100 analysts in 10 different industries.<sup>71</sup>
- The “Auditor view” series – publications that offer investors insight into audit in a given industry.<sup>72</sup>

<sup>68</sup> A more comprehensive review of our activities may be found in Exhibit 6 a paper entitled “Corporate Reporting team’s research and engagement activities”, dated June 2012.

<sup>69</sup> We attach as Exhibit 7 a paper prepared by Price Waterhouse in 1997 that sought to meet investor demands for increased transparency by encouraging companies to improve corporate reporting.

<sup>70</sup> In particular, the principles behind the Building Public Trust initiative are: “(i) to encourage organisations to offer better not just more information; (ii) to improve the linkage between what is being reported and strategy; (iii) to ensure narrative statements are backed by good data; and (iv) critically that historical performance is set in context, particularly in respect of future ambition.” BPT Speech (page 2). See also MFQ Response (response 113 [><]).

<sup>71</sup> We share insights from this initiative - and from our broader investment community engagement programme - with companies through a number of channels, including our popular “Investor view” series. Examples of these publications may be found at: <http://www.pwc.com/gx/en/corporate-reporting/investor-views/>.

<sup>72</sup> This may be found at: <http://www.pwc.com/gx/en/ifrs-reporting/publications/index.jhtml?category=issue&filter=/gx/ifrs-reporting/auditor-view>.

**(2) Encouraging improvements in corporate reporting**

The insight gained as a result of engagement with investment professionals informs product development and the wider corporate reporting debate. For instance:

- We have had a central role in the creation of the International Integrated Reporting Committee (IIRC) - a multi-stakeholder initiative that is working to develop a corporate reporting framework that offers a more comprehensive assessment of company performance.
- Our research provides the intellectual capital that underpins our widely-acclaimed corporate reporting framework used by companies. This framework underpinned the Government's Operating and Financial Review requirements, the WICI framework,<sup>73</sup> the Enhanced Business Reporting framework, the IIRC's reporting framework, and others.
- We engage with companies, standard setters and regulators through publications (such as our "Investor view" series), the development of templates for enhanced disclosures (e.g. the Report Leadership initiative), and the identification of good reporting practice examples.
- Our research led to development of PwC benchmarking tools that help corporate entities identify areas where they might enhance the usefulness of their disclosures.
- We were credited as the driving force behind the FRC's Financial Reporting Lab and were heavily involved in taking the concept of the Lab to its formal launch in October 2011.<sup>74</sup>

*Innovation in the delivery of our audit service*

3.11 The audit process in respect of large companies today is far more sophisticated than it was ten years ago. As a consequence there have been not only additions to our audit process, but significant incremental innovations and refinements to our audit methodology.

- (a) We attach a summary of changes to the broader audit methodology over the last ten years as Exhibit 8 which shows clearly how we have had to adapt our offering to company and regulatory demands;
- (b) This innovation also occurs at individual client level. During the CC's site visit we described the [X] audit, and we set out in Exhibit 9 details of how that audit has been transformed in response to changes in the client organisation and demands over the last decade. This responsive approach to the needs of our clients is consistent with the innovation expected in a competitive market. Our response to Question 103 MFQ also set out details of client-specific innovations in relation to delivery of audits to a variety of companies; and
- (c) In our Submission we have provided a detailed description of the investments we have made, and continue to make, to improve our processes by increasing efficiency and quality, and to improve our ability to judge the robustness of financial statements. One particular example is

---

<sup>73</sup> The World Intellectual Capital Initiative, a global business reporting framework. See <http://www.wici-global.com/>.  
<sup>74</sup> See the FRC's press release it issued with the Effective Company Stewardship report in January 2011, available at <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2011/January/FRC-proposes-enhancements-to-Company-Reporting-and.aspx>.

the £37 million invested by us in the Aura methodology software as part of our Audit Transformation Programme.<sup>75</sup>

*Innovation in the value and insight provided to companies*

- 3.12 As previously evidenced to the CC, we also innovate in offering added value and insights to companies to improve their performance during the course of the audit, particularly around industry developments and controls effectiveness.<sup>76</sup>
- 3.13 These developments have been in response to company demand and competitive pressure requiring us to improve the quality as well as the efficiency of our audit service.<sup>77</sup> The very substantial levels of investment made over considerable timeframes<sup>78</sup> rebut the suggestion that audit partnerships are run on a “cash-in/cash-out” model.<sup>79</sup> Indeed, the partnership model is far more likely to incentivise and facilitate long-term investments than one driven by the shorter-term horizon of many investors. As we have explained in detail, the investments PwC UK partners made in supporting the development of the PwC network of member firms are evidence of this long-term perspective.<sup>80</sup>

---

<sup>75</sup> See our Submission (4.24 to 4.28 and Annex 6) (covering our Audit Transformation Programme), and MFQ Response (response 103). In particular, at paragraph 3.37 of our Submission, we noted that total global development costs of the Aura project are estimated to be US\$400 million. Of this amount, the contribution from PwC UK is approximately £[redacted]. The PwC network’s central Aura team estimates that in-territory implementation costs across the PwC network of firms are a further US\$400 million.

<sup>76</sup> See MFQ Response (response 103 [redacted] and response 104) and Annex 5 of our Submission.

<sup>77</sup> For example, Aura, the electronic tool (discussed in paragraphs 2.39(c)(ii), 3.36 - 3.39 of our Submission) [redacted]. See also MFQ (response 103).

<sup>78</sup> See our Submission (paragraphs 4.24 to 4.28).

<sup>79</sup> See Summary of Investor Hearing (paragraph 41).

<sup>80</sup> See MFQ (response 15) and our Submission (Paragraph 2.39(c)(i)). In addition, as noted in the MFQ Response (response 26) we have also made significant long-term investments - [redacted]

## 4 Auditor reputation reflects customer experience

- 4.1 In the vast majority of cases where a FTSE 350 company switches audit firm, or considers doing so, it will choose one of the largest audit firms as an alternative to its existing audit firm - this is shown in the historical record.<sup>81</sup> This does not reflect inertia or an unwillingness to instruct an alternative audit firm (because the company is considering a switch) but a positive decision to instruct one of the largest audit firms where a new firm is to be instructed.<sup>82</sup> This is the case even where mid-tier firms are invited to tender or where they are the existing auditor.<sup>83</sup> This preference was shown when Arthur Andersen closed and companies had to switch auditor without facing avoidable switching costs: no FTSE 350 companies chose to move to a mid-tier firm.<sup>84</sup>
- 4.2 Those who argue that such decisions to instruct the largest audit firms do not reflect a real differentiation between the largest audit firms and the mid-tier are therefore suggesting a market-wide level of irrationality on the part of highly experienced executives who sit on audit committees and boards. We have seen nothing in any of the submissions to the CC to explain persuasively why those who make purchasing decisions for audited entities might engage in such irrational behaviour - and any suggestion that where our alumni now hold senior positions at large companies they prefer to use us (or other large audit firms) without good and objective reasons is without foundation.
- 4.3 In the following paragraphs we first explain why reputation reflects reality and then why the suggested evidence to the contrary does not stand up to scrutiny.

### ***Reputation reflects reality***

- 4.4 The behaviour of large companies in preferring large audit firms over the mid-tier firms reflects the fact that the largest audit firms have qualities that make them particularly well suited to the audit of large companies.<sup>85</sup> As the Hundred Group states: *"In our opinion the Big Four bias exists because the quality, breadth and experience offered by the Big Four is unmatched by other providers."*<sup>86</sup>
- 4.5 We recognise that our reputation is critical to our ability to continue to win large company audits, and our desire to maintain this reputation drives our constant endeavours to improve audit quality. The importance of reputation is shown in the efforts we make to monitor our reputation with those responsible for audit purchasing recommendations (management and audit committees) - see Box 4 below.

---

<sup>81</sup> See our Submission (Figure 3, page 70).

<sup>82</sup> We also explained in our Submission the ways in which large companies regularly monitor and review their choice of audit firms - see Section 5 of our Submission covering the third pillar of our case - large companies are effective purchasers.

<sup>83</sup> See our Submission (paragraphs 4.4 to 4.15 and Figure 7).

<sup>84</sup> Mid-tier firms also did not recruit significant numbers of Arthur Andersen partners (an investment which might have increased these firms' abilities to win large company audits in the future).

<sup>85</sup> See Section 3 of our Submission covering the first pillar of our case - large companies require a distinct service.

<sup>86</sup> Hundred Group Submission (page 2).

**Box 4 - Brand Health Index**

We have previously referred to the Brand Health Index (**BHI**),<sup>87</sup> bespoke research commissioned by PwC which we use in tracking our reputation in the market. It is worth noting in this respect that:

- (a) We do not in the BHI survey seek the views of respondents on firms other than the four largest firms (i.e. those we view as our main competitors); and
- (b) Brand health (as an indicator of reputation) is dynamic and we have seen significant improvements over time in particular areas as against our competitors. Consequently, we have to continually make efforts to improve our audit quality in order to ensure that our reputation - and our brand health - remains competitive.

In the latest survey, PwC's BHI score increased from 109 in 2008 to 125 in 2012 (a 15 per cent increase) while our overall BHI ranking rose from second in 2008 to first in 2010 and 2012.<sup>88</sup> The Assurance business (where we ranked first) also improved its score from 125 in 2010 to 129 in 2012.<sup>89</sup>

The BHI survey also measured the views of audit committees. The survey shows that audit committees awarded PwC the highest overall BHI score of the four largest audit firms (Slide 10), and the highest score for most of the categories on which they commented.<sup>90</sup>

- 4.6 However, building and protecting our market reputation is not primarily a marketing exercise. Our reputation is dependent on continuous investment in efficiency, quality and performance and efforts to differentiate ourselves from others in terms of the delivery of our service. Without a strong reputation, we would be unable to compete effectively. Box 5 below explains how this position is consistent with the relevant economic literature.

**Box 5 - Economic theory regarding role of reputation**

The strong market view that the largest audit firms offer superior quality compared to the mid-tier firms when it comes to the audit of large companies is grounded in the reality of the market experience of those responsible for acquiring audit services. This experience leads to reputations which are developed over time through frequent interactions between audit firms, individual companies, executive and non-executive directors and regulators.

In a competitive market, delivering on quality and value, and maintaining positive customer feedback and thus reputation, requires substantial and continued investment in providing customers what they want. In relation to large company audits, this means investing in good quality knowledge, personnel, methodologies, network etc.

---

<sup>87</sup> See MFQ Response (response 27).

<sup>88</sup> See Slide 9 of the BHI presentation, attached as Exhibit 10.

<sup>89</sup> See Slide 14 of the BHI presentation.

<sup>90</sup> These categories were: "*familiarity*" (Slide 26), "*overall consideration*" (Slide 28), "*first choice*" (Slide 30), "*overall usage*" (Slide 32), "*main provider of services*" (Slide 34), "*loyalty*" (Slide 37), "*provides leading edge advice*" and "*inspires confidence*" (both Slide 51).

There is well-established economics literature that demonstrates that:

- Market reputation over time will reflect reality and it is not possible for a low quality or inefficient supplier to obtain (or retain) a market reputation for high quality or efficient services. This means:
  - if the reality changes (for example if a previously high quality supplier ceases to offer high quality services) the market will respond to such messages and the supplier's reputation for quality will be lost and its business will consequently suffer; and
  - if a lesser quality supplier invests in the attributes to enable it to offer higher quality services, over time the market will recognise and respond to this and the supplier will win market share.
- Reputation in this way enhances market efficiency by ensuring that suppliers invest and innovate to offer quality services, and deliver them in an efficient manner. It also helps purchasers make informed purchasing decisions.
- In a sophisticated market such as that for audit services, because reputation reflects the reality of performance, it ensures that firms invest to a level that optimises their ability to deliver effective and efficient services to meet customer needs and that buyers acquire services from firms who have demonstrated that they possess the necessary attributes. This may lead to a higher level of concentration than in markets where reputation is less important because purchasers over time have focussed their business on the best suppliers.<sup>91</sup>
- Thus reputation is market driven - because it reflects the experience of consumers of services - and in turn gives reliable signals to suppliers and purchasers about market performance.<sup>92</sup>
- Moreover, the large company audit market has developed in the way in which this theory would suggest - buyers have purchased from large firms with strong reputations, that have been incentivised and remunerated to invest in quality to deliver the audits the market needs. Such market structures are more efficient than alternative structures where quality, investment and reputation have less significance – precisely because they have evolved to respond to buyers' needs.

***The evidence from the mid-tier regarding the role of reputation is misconceived***

- 4.7 The evidence advanced by mid-tier firms that the reputation of the large firms does not reflect reality cannot be substantiated:

---

<sup>91</sup> The relationship between investments and market structure is covered by Sutton (1991) "Sunk costs and market structure", Cambridge/Mass: MIT University Press. The manner in which the interplay between reputation and competition can increase concentration and welfare is covered by Huck, Luenser and Tyran (2006) "Competition fosters trust", mimeo, University College London.

<sup>92</sup> The way in which reputations can improve market efficiency by aiding customers' ability to efficiently distinguish between high and low quality providers can be seen in a number of academic papers including: (a) Bolton, Katok and Ockenfels (2004), "How effective are electronic reputation mechanisms? An experimental investigation", *Management Science* 50, 1587-1602; (b) Bohnet, Harmgart, Huck and Tyran (2005) "Learning Trust", *Journal of the European Economic Association* 3, 322-329; and (c) Bohnet and Huck (2004), "Implications for trust and trustworthiness when institutions change", *American Economic Review* 94, 362-366.

- (a) Grant Thornton states that “[t]he reputational barriers and restrictions over the choice of auditor are demonstrably not related to capability or quality of the audit firms involved, as supported by inspection reports issued by regulators”.<sup>93</sup> The statement that regulators support the view that there is no difference in quality between the large and the mid-tier firms is incorrect. As explained above, the AIU is explicit that its public reports: “do not provide a comprehensive basis for assessing the comparative merits of individual firms.”<sup>94</sup> Mid-tier firms audit currently only one FTSE 100 company and 13 FTSE 250 companies between them, so their client base will inevitably lead to the AIU reviewing audits of far smaller companies in relation to mid-tier auditors than in respect of the large audit firms. By comparison, 44 per cent of PwC’s AIU reviews in the last five years have been of audits of FTSE 100 companies and a further 22 per cent of FTSE 250 companies, with the remainder including large private companies. There is therefore no basis for comparing AIU review outcomes in respect of the largest audit firms with those of mid-tier firms given that the mid-tier inspections are generally of far less complex audits;
- (b) Grant Thornton also states that “[t]here is a misplaced perception amongst Audit Committees that the Big-4 auditors possess a range of attributes (such as greater resources, an international network, greater experience, the ability to recruit higher calibre staff etc.) necessary for auditing large companies, which the other auditors do not (and cannot) possess.”<sup>95</sup> However, if one considers each of the “necessary” attributes described in parenthesis in the above quotation it is self-evident that the largest four firms do possess such attributes to a greater extent than mid-tier firms. The large firms clearly have greater experience of auditing larger companies and demonstrably have greater capabilities as a consequence of the resources available to them than do the mid-tier firms (for example in terms of number of staff, size of network etc). It is also clear from undergraduate recruitment surveys that the largest four audit firms are considered by undergraduates as more attractive employers than the mid-tier firms, suggesting that the largest firms are able to recruit undergraduates of better calibre.<sup>96</sup>
- (c) The examples mid-tier firms have provided of carrying out large and complex audits are not persuasive:
- (i) Grant Thornton has cited a FTSE 100 company for whom it carries out 150 subsidiary audits. We believe it is referring to certain wholly owned largely non-operating subsidiaries of Rio Tinto where PwC is the group auditor. While Grant Thornton provides audit services for some of Rio Tinto’s subsidiaries (following a competitive tender process), these subsidiaries are not within the scope of the group audit, the audit work is relatively straightforward and it is performed substantively (i.e. with no reliance on systems or controls).<sup>97</sup>

---

<sup>93</sup> GT Response to Issues Statement (paragraph 7.3(c)).

<sup>94</sup> AIU 2012 Report (page 19).

<sup>95</sup> GT Response to Issues Statement (Paragraph 7.3(d)).

<sup>96</sup> We have been voted the country’s leading graduate employer in *The Times* Top 100 Graduate Employers survey for eight successive years. See our Submission (paragraphs 3.18(a) and (c)).

<sup>97</sup> See GT Response to Issues Statement (paragraph 4.2(b)) where GT claims that it audits approximately 150 of a FTSE 100 listed company’s subsidiaries across 25 countries as evidence of its capabilities and that it can provide these services at lower cost. The CC should appreciate that the subsidiary audits undertaken by GT are not of sufficient scale to be within scope for the group audit. These audits are largely straightforward, not significant to support the Group audit opinion, and do not require the same level of industry and other audit expertise that is deployed on the Group audit (such as an understanding and evaluation of complex IT systems). For these relatively straightforward audits Rio Tinto viewed the auditing of the entities as a compliance activity, and alongside simplifying their internal structure was also interested in a low cost solution and appointed

- (ii) Mazars asserts that it audits five of the world's largest companies. In fact, Mazars has a joint audit role on the audits of five leading French companies (where joint audits are prescribed by law), and – in the case where they work with PwC - their work typically represents around 30 per cent of the total group audit fee.<sup>98</sup> This does not demonstrate that large companies would choose to instruct Mazars if they were not compelled to use a second audit firm.
- (iii) [redacted]<sup>99</sup>
- (d) In fact the mid-tier firms themselves recognise that they have lesser attributes and resources than the largest firms:<sup>100</sup> *“we have the attributes, capability and the resources (both in the UK and internationally) to audit the majority of the FTSE 350”*<sup>101</sup> (emphasis added) and *“the BDO network is large enough to audit almost all companies, including companies within the Reference Market, with the exception of the largest and most complex companies and financial institutions”*<sup>102</sup> (emphasis added).
- 4.8 There is a suggestion that it is not only management, audit committee and non-executives, but also brokers, lawyers and bankers who perceive the largest audit firms as offering a better service, and that were a company to appoint a mid-tier firm as auditor this might undermine such third party confidence in the audit.<sup>103</sup> This may be so, but all this demonstrates is that the reputation of the largest firms for better quality is shared by all stakeholders who have market experience. Lenders - for example - are debt investors in companies, and their views of which firms provide audit quality should not be dismissed.
- 4.9 Finally, it has been suggested that the largest firms have better links with audit committee chairs and finance directors, particularly through alumni, and that this in some way prejudices such individuals in favour of the large firms.<sup>104</sup> Any suggestion of inappropriate bias by such individuals is wrong and without foundation:
- (a) Quite simply, audit committee chairs and finance directors have no incentive to be loyal to a firm that is not providing the requisite quality or a competitive service. Decisions as to which audit firms to recommend for appointment will in reality reflect the experience of audit committee chairs, finance directors and their colleagues of having worked with particular audit firms. If the audit firm's service delivery was to fall short of what was expected, or if such firm started to lose

---

GT. The level of investment needed to undertake a group audit of the complexity and scale required for Rio Tinto is disproportionate to that needed for these subsidiaries and hence a price differential is entirely rational.

<sup>98</sup> See Mazars Submission (paragraph 2). See our Submission (paragraph 3.57 - 3.58) for further examples of mid-tier firms failing to demonstrate the required quality when put to the test by large companies.

<sup>99</sup> [redacted]

<sup>100</sup> Summary of BDO Hearing (paragraph 7); GT Response to Issues Statement (paragraph 1.8)., Smith and Williamson Response to Issues Statement (paragraphs 4 and 5); Summary of GT Hearing (paragraph 10).

<sup>101</sup> GT Response to Issues Statement dated 20 January 2012 (paragraph 1.5).

<sup>102</sup> BDO Response to Issues Statement (paragraph 2.3).

<sup>103</sup> BDO Response to Issues Statement (paragraph 5.1.2).

<sup>104</sup> See GT Response to Issues Statement (paragraph 7.3(f)) and BDO Response to Issues Statement (paragraph 5.3.11). We also note the Summary of Investor Hearing recorded the following: *“The representatives considered that the reason why the audit firms competed so fiercely for talent in the recruitment market was because even if recruits did not stay with the firm, there was a good chance they would become a source of revenue for the firm in subsequent positions they took up. There was also an element of such alumni being alumni for the Big 4 rather than for a specific firm, ie they would favour the Big 4 over mid tier firms. Big 4 firms successfully placed secondees in Whitehall, within regulators, standard setters and within Brussels”* (paragraph 48). This proposition is unfounded and illogical: personnel are not appointed in order to become alumni, and while of course there is value to large firms in having alumni in senior positions who recognise their quality, these alumni would only seek to appoint such firms if they believed in their quality, as this would otherwise reflect badly on the individuals concerned.



its market reputation for competence, it would be foolhardy and irrational for audit committee chairs and others to risk their own and their company's reputation out of misguided loyalty. No evidence of circumstances where this has happened has been put forward; and

- (b) the further proposition that such loyalty extends beyond the particular audit firm where the individual has previously worked,<sup>105</sup> or with whom they have had a relationship, to *all* large audit firms<sup>106</sup> (but does not extend to mid-tier firms) is entirely without logic.

---

<sup>105</sup> Many of our alumni spent only a few years with us at the outset of their careers.  
<sup>106</sup> Mazars Submission (paragraph 18).