PwC's response to the CC's Notice of a Further Possible Remedy

1 Introduction

1.1 This submission sets out PwC's response to the Competition Commission's (**CC**'s) notice of a further possible remedy (published on 5 June 2013) (the **Notice**) of giving the Financial Reporting Council (**FRC**) a secondary duty to promote competition between firms providing audits to FTSE 350 companies. This submission also responds to the CC's specific questions of whether giving the FRC such a secondary duty will assist:

(a) companies in comparing auditors; and

(b) shareholders in influencing the auditor appointment decision of companies in which they hold shares.

1.2 We support the FRC having a secondary duty to promote competition as part of its overall objectives, provided – as is made clear in the Notice[1] - the FRC retains its primary focus on audit quality (the FRC's primary mission should remain to *"promote high quality corporate governance and reporting to foster investment"*)[2]. We agree with the CC that any such secondary duty should not have powers concurrent with the Office of Fair Trading to enforce competition rules.[3]

1.3 We agree that such a secondary duty could assist companies - acting through the Audit Committee (**AC**) - in comparing audit firms. It could also assist shareholders in influencing the auditor appointment decision, when coupled with other remedies set out in the Remedies Notice (published on 22 February 2013) (the **Original Remedies Notice**).[4]

1.4 We agree that these two effects could be achieved, as explained in the Notice,[5] by requiring the FRC to consider how it might review and report on auditors of large companies in a way which promoted competition. We consider the way in which the Audit Quality Review (**AQR**) team might facilitate greater comparison of audit quality in section 2 below.

1.5 However, in our view, such a secondary duty to promote competition should not be confined to altering the way the AQR team approaches the assessment and reporting on audit quality; rather, it should influence the way in which the FRC engages more broadly with the FTSE 350 audit market. We outline these additional benefits in section 3 below.

2 Comparison of audit quality

2.1 At present, the AQR team produces annual reports for the four largest firms (which for 2012/13 were published by the FRC on 31 May 2013) and an overall Annual Inspection Report which covers the four largest firms and draws out overriding trends and themes from the individual

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1 At paragraphs 6, 8 and 10. References to paragraph numbers are to the Notice, unless otherwise stated.
2 As we set out in our post-hearing submission dated 23 May 2013 at pages 2 to 3.
3 At paragraph 7.
4 In particular, Remedy 5 (i.e. strengthened accountability of the auditor to the AC) and Remedy 6 (i.e. enhanced shareholder-auditor engagement) of the Original Remedies Notice.
5 At paragraph 17.

inspection reports (the 2012/13 Annual Inspection Report was published on 29 May 2013).[6] Currently, mid-tier firms are reviewed bi-annually whilst the four largest firms are reviewed annually.

2.2 As acknowledged by the Notice (and emphasised by the AQR team) the AQR team's reports do not currently allow for direct comparability of audit quality between the audit firms. In fulfilling the FRC's primary duty, a great strength of the current AQR regime is that it allows themes across audit firms to be identified for improvement – and we believe that this feature should be preserved in the interests of the FRC's primary duty to protect audit quality. Another strength is the AQR team's recent focus on evaluating and reporting on firms' tone at the top and firm level processes to ensure quality, which we also believe is critical to the monitoring and setting of high standards of audit quality.

2.3 However, preserving these attributes of the current audit inspection regime need not be inconsistent with providing more useful information on audit quality to companies and shareholders to allow them to compare auditors. For example, the FRC might consider the relative merits of conducting more reviews (perhaps with a narrower scope from the current review) so as to increase the sample of inspections and/or to publish its findings in a way which allows for greater comparability between audit firms, without reducing the reporting regime to a quantitative scoring exercise.

2.4 While the AQR team's reports capture an important aspect of audit quality, it is important to note that they do not in themselves provide companies or shareholders with sufficient or adequate information to make comparisons between audit firms. To allow ACs to take a more holistic view of the appropriate audit firm for their company, they would need to have regard to matters such as a firm's sector and territory strengths and the composition and expertise of the proposed team. To reflect this broader view of audit quality, in addition to potentially modifying the audit inspection regime, the FRC might also consider whether it might be appropriate to:

(a) introduce a "comprehensive audit firm review" as suggested by the Canadian Public Accountability Board (in their letter to the CC dated 18 March 2013); and/or

(b) allow for greater comparability between audit firms by enhancing the provision of information in audit firms' respective transparency reports. Enhanced transparency reports might include, as we already currently provide in our annual transparency reports: results of the AQR team's most recent review of the firm's audit engagements; details on the firm's own internal quality monitoring programmes, engagement quality control reviews and procedures; and information on the firm's independence policies and the systems that are in place. Such reports would provide a further source to enable companies to better compare firms and would inform shareholders so as to assist with formulating their views vis-à-vis audit firm appointments.

2.5 As a separate point, while the AQR team's reports are an indicator of audit quality, as we have stated previously, we are concerned that the CC has reached incorrect provisional conclusions based on them. Contrary to the suggestion in the Notice that the AQR team reports over the period 2007 to 2011 show that a majority of FTSE 350 audits inspected required at least some level of improvement[7] (which the CC seeks to rely upon in reaching the provisional conclusion

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[6] The AQRT reports are available on the FRC website, and the link to the overall Annual Inspection Report for 2012/13 is as follows: http://frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Inspections-Annual-Report-2012-13.aspx

[7] At paragraph 15.

that there were "*significant, persistent and widespread concerns regarding the quality of audits delivered to the FTSE 350 companies as identified by the AQRT*"[8]) this is not how these AQR team reports should reasonably be interpreted. The CC seeks to support its provisional conclusion solely on the basis of the AQR grading system and fails to appreciate the nuances in the AQR team's reporting, while discounting evidence that the CC accepts could equally suggest audit quality is high. In fact, as a regulator whose function it is to continuously improve audit quality, the AQR team identifies examples of how audit quality can be improved by focusing on more complex audits and its conclusions do not demonstrate that there is "persistent and widespread" "audit failure" across the market. Indeed, even on audits that are graded as "good" (the highest grade), the AQR team will nevertheless identify suggested recommendations for improvement.

2.6 Furthermore, the most recent 2012/13 inspection results published in May 2013 show an improvement in the overall standard of audit work from 2011/12. This was most evident in the FTSE 350 audits where out of 33 audits examined, only two (6%) were identified as "needing significant improvement" (2011/12 - three audits - 8%); and 26 FTSE 350 audits (79%) received the highest grade shown by the AQR team, being rated as "good with limited improvements required".[9] We acknowledge that there are areas for further improvement in audit quality and we have in place a comprehensive action plan to address the points raised by the AQR team. However, we firmly believe that the AQR team's 2012/13 Annual Inspection Report provides further evidence that the CC's assertions regarding the quality of FTSE 350 audits are not justified.

3 Additional benefits of the FRC having a secondary duty to promote competition

3.1 In addition to having a positive impact with regard to the AQR team's role and allowing greater comparability between audit firms, a secondary duty for the FRC to promote competition could also have a number of other benefits.

3.2 For example, a secondary duty to promote competition in the audit market might influence the guidance the FRC provides to ACs, such as promulgating best practice for running tenders. It would also be consistent with extending the externally facilitated board effectiveness review, required every three years under the Code, to expressly include the AC.

3.3 Such a secondary duty would also require the FRC to consider the effect on competition of the new tendering regime. Although stakeholders' responses to the FRC's consultation on introducing tendering on a "*comply or explain*" basis every ten years reflected their views on improving competition, in assessing the effectiveness of the new tendering regime in the future a secondary duty to promote competition would require the FRC to consider its impact on competition in the market.

3.4 In this respect, the new tendering regime is now having a significant effect on the FTSE 350 audit market. In our experience, the implications of the new tendering regime are on the agenda of most ACs (and are already expressly referred to in over 20 FTSE 350 companies' annual reports). Indeed:

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[8] See paragraph 7.121 of the CC's Provisional Findings report (22 February 2013) (the **PFs**).
[9] As shown in the table on page 6 of the AQR team Annual Inspection Report for 2012/13.

(a) based on company specific information and on our understanding of partner rotation timings across the FTSE 350, we anticipate around 43 FTSE 350 tenders in 2013, of which we have participated in, or have been notified of, 13 to date and are aware (based on discussions with companies) of at least a further 13 being planned; and

(b) significant developments in the market have already taken place since the changes were announced, with HSBC for example announcing a tender ([✂]); and BG, RSA, Cairn Energy and Land Securities deciding to switch auditor following a tender.

3.5 The substantial increase in the number of tenders and switches taking place among large companies demonstrates that the new tendering regime is having a real and sustained impact on the FTSE 350 audit market. The evidence shows that large companies take compliance with the Combined Code seriously and that substantial increases in tendering activity is not a passing trend but is a new and permanent feature of the market.

3.6 In these circumstances, and for the reasons we have previously explained in detail[10], we believe that the existing tendering regime should be given an opportunity to become established and its results assessed before further changes are made. As we have explained in our Response to the Remedies Notice, we support those remedies designed to empower the ACs and shareholders in overseeing the audit process. By contrast, we are firmly opposed to mandatory firm rotation in any form, which is a highly intrusive measure that disenfranchises ACs and shareholders and reduces choice for companies. It is not justified by the evidence and would produce disadvantages that are significantly disproportionate to its aim.

PricewaterhouseCoopers LLP

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[10] See Section 3 of our Response to the PFs and the Original Remedies Notice dated 22 March 2013 (**Response to the Remedies Notice**).