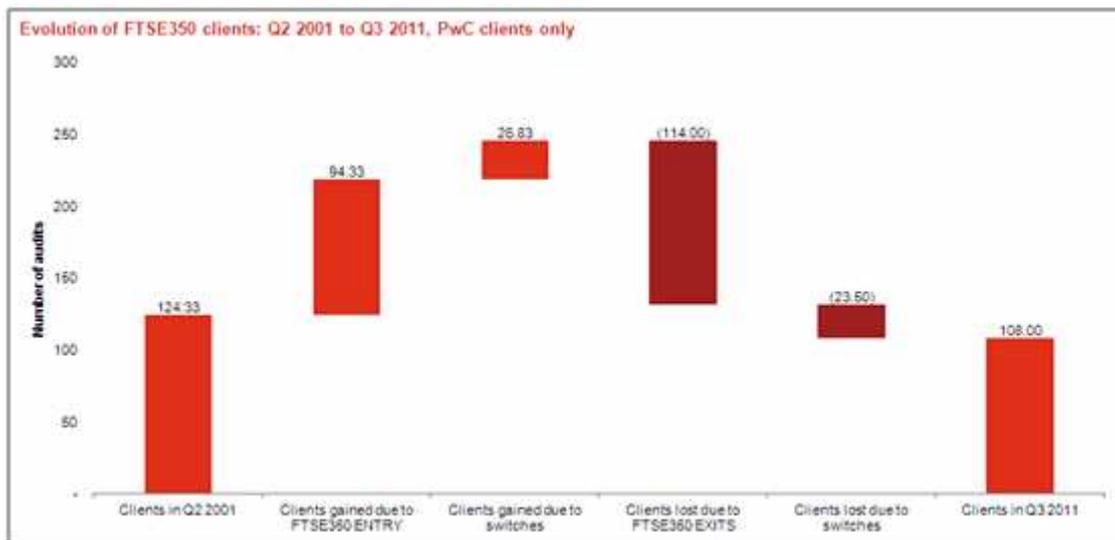


PwC response to Firms' Stated Competitive Strategies working paper

- 1 This paper sets out PwC's response to the Firms' Stated Competitive Strategies working paper (**Competitive Strategies WP**). We have set out in the attached Annex our more detailed comments on the individual paragraphs of the Competitive Strategies WP.

Summary

- 2 As we have explained from the outset of this process, we consider that the evidence demonstrates that there is strong competition to provide a quality audit service in an efficient manner at a competitive price. As demonstrated by the Competitive Strategies WP Annex, all audit firms have strategies in place both to win new audits and to retain business, particularly given strong competition from rivals. This is a dynamic market, with uncertainty about who the large companies of the future will be,¹ and constant changes in the constitution of the FTSE 350 due to mergers and acquisitions. This was shown clearly in the following graph from our Initial Submission (included as Figure 4):



- 3 It follows that all audit firms need an active targeting programme merely to maintain their market position, and especially to increase market share. [X]²
- 4 The Competitive Strategies WP highlights numerous examples of behaviours which are consistent with a competitive market, in terms of efforts to increase market share and responding to pressure from existing clients on price and quality. This evidence is entirely inconsistent with an uncompetitive market. For example (emphasis added below):

¹ The percentage of new entrants that are audited by PwC varies considerably (fluctuating between 10% and 32% over the last ten years). See also Figure 6 in our Submission and Response to the Issues Statement of 12 January 2012 (our **Initial Submission**) which shows the dynamic competition that takes place. The dynamic nature of the market is also shown by the infographic which is available on our website: <http://www.pwc.co.uk/who-we-are/the-uk-statutory-audit-market-infographic.html>. We therefore face a challenge every year in maintaining or improving our share of companies in the FTSE 350.

² [X<]

- Paragraph 4: “All the firms have adopted in some form the **strategic objective of increasing their market share and revenue and to that end have instigated arrangements to win new clients.**”
- Paragraph 8: “Across the firms, there is a view that [clients] **put increasing price pressure on their auditors.**”
- Paragraph 9: “[B]ecause of the uncertainty in implementing fee increases, the firms place much greater **emphasis on reducing costs and identifying efficiencies**”.
- Paragraph 18: “[F]irms consistently refer to the **importance of building relationships with clients before a tender situation occurs**”.
- Paragraph 21: “Companies wish their auditor to have **sector expertise, which gives them a competitive advantage**”.

5 We believe the statements above are accurate and show that the firms compete aggressively with each other, including outside the context of tenders where they seek to build relationships with companies. They also show that large companies are sophisticated purchasers who value expertise, and have been able to push down prices, forcing audit firms to innovate and increase the efficiency of their services in order to protect margins.

6 In light of this evidence, we object to the Competition Commission (**CC**) describing some observations as representing only the view or belief of the audit firms and in certain instances seeking to downplay the extent of competition. We believe that, in doing so, the CC does not have proper regard to the available evidence. For example, the CC characterises the existence of price pressure as being only the “view”³ of the firms, when this price pressure is demonstrated unequivocally in the data:

(a) The CC’s descriptive statistics show clearly that audit fees have been driven down by companies in recent years: average auditor hours per engagement have remained broadly static from 2006 to 2011, while average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms).⁴

(b) [§<]

7 We highlight below the key issues that we consider are not properly reflected in the Competitive Strategies WP. To an extent, these issues overlap with the CC’s analysis in the Nature and Strength of Competition working paper (the **Nature and Strength of Competition WP**), to which we respond separately.

There is a real and persistent threat of a client going out to tender

8 The Competitive Strategies WP states that the “...frequency of this threat [to tender] occurring and the likelihood of a client following through is not apparent”.⁵ We explain in more detail in our response to the Nature and Strength of Competition WP that this misunderstands the

³ Paragraph 8 of the Paper.

⁴ See paragraph 35 of the CC’s working paper on Descriptive Statistics and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - “Engagement Data Descriptive Statistics - PwC”).

⁵ Paragraph 8 of the Paper.

competitive pressure exerted on the existing audit firm by the possibility that the company will go out to tender. Large companies can use the threat of tender - whether implicitly or explicitly - to achieve highly effective outcomes from their existing audit firm; audit firms know tenders are a possibility, and a likelihood if audit service falls below competitive service. In summary, our position is as follows:

- (a) The likelihood of a client following through on a threat to tender is real.
 - (i) It is clearly demonstrated at a general level from the number of tenders which take place. We estimate this to be around 14 tenders on average per year within the finite population of the FTSE 350.⁶
 - (ii) Our own experience shows that we appreciate that the likelihood of clients following through on threats to tender and ultimately switching is very real:
 - (A) [redacted]: The audit was lost having been put out to tender after we were judged to have insufficiently highlighted business control issues [redacted]. In particular, “[t]he issue [redacted] had caused a feeling that concerns ought to have been raised more strongly than they were.”⁷
 - (B) [redacted]: The audit was put out to tender because the company felt that [redacted] had “taken their eye off the ball” and that “[redacted] hadn’t taken on board how much [redacted] had changed as a business over the years and the fact that their focus was now global, [redacted] approach was UK-centric”.⁸ Our interaction with [redacted] had picked up this concern with [redacted] and resulted in [redacted] being a “Tanks on Lawns” target. The company’s decision to tender is viewed by us in part as due to the success of our targeting efforts.
 - (C) [redacted]: The audit was put out to tender by the company following “a perception that the audit fee was too high amongst Executive Management.” In fact, it was “[a]greed that the audit would not have gone out to tender in 2009/2010 had it not been for the pricing issue of the past.”⁹
- (b) Given the sophistication of the buyers in this market¹⁰ (who know, as do we, that a tender would involve costs for both parties¹¹), the threat to tender need not be made explicitly or be carried through in order to be effective. The threat of tender is always implicit during the annual negotiations that take place for appointment. This is a highly effective way of ensuring that audit firms provide competitive quality and value for money.
 - (i) The use of this threat to tender (and switch) is demonstrated repeatedly in the evidence available to the CC. It includes the following:

⁶ See paragraph 91 of the working paper on Evidence relating to the Selection Process which records that 69 tenders took place between 2007 and 2011.

⁷ See Exhibit 127 to our Initial Submission: [redacted]

⁸ See Exhibit 128 to our Initial Submission: [redacted]

⁹ See Exhibit 60 to our Initial Submission: [redacted]

¹⁰ As recognised in a number of places by the CC in the Nature and Strength of Competition WP, see paragraphs 75 - 78.

¹¹ See our response to the Switching Costs WP.

- (A) The Hundred Group of Finance Directors: *“audit firms know that we have a choice and that very often is all you need to keep their pricing and the quality of their service honest”*.¹²
 - (B) The case studies: For example, in Company G case study the ACC said that *“PwC knew only too well that the company could tender and so there was a dynamic mutually respectful relationship”*.¹³
 - (C) The CC’s Survey¹⁴: This makes clear that customers are able to judge, and demand to receive, a quality service at a competitive price - and are likely to go to tender if they do not. Those factors most likely to lead companies seriously to consider changing their current statutory auditor include 86% of FTSE 350 companies which said they would consider switching due to “complacency of the audit firm”; 71% cited “increase in price”; and 61% cited “problematic relationship between auditor and management”.¹⁵
- (ii) As the CC explicitly recognises in other working papers, companies are:
- (A) well-informed as to the alternatives available to them¹⁶ as demonstrated by the CC’s Survey which shows that for FTSE 350 companies, 78% of companies are approached, formally or informally, by other audit firms every year, 88% every two to three years and would therefore be inconsistent with any suggestion that companies are unaware of the alternatives available to them;¹⁷
 - (B) monitor closely the quality and value for money of their current audit service¹⁸ as demonstrated, for example, in the Company I case study where the FD wanted to understand where the audit hours were being spent and to make sure that the number of hours was appropriate;¹⁹ and
 - (C) push for improvements with the implicit threat of tender.
- (c) In the face of these threats to tender, we go to great lengths to ensure that the large companies we audit are satisfied with the quality, efficiency and value of our service - and the evidence shows that we achieve this.

¹² Mr Ashley Almanza, Chairman of The Hundred Group (of Finance Directors of FTSE 100 companies) and Chief Financial Officer of BG Group. In evidence to the House of Lords Economic Affairs Select Committee. See <http://www.publications.parliament.uk/pa/ld201011/ldselect/ldconaf/119/11905.htm#n14>.

¹³ Paragraph 75 of the Company G case study.

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

¹⁵ See slide 68 of the CC’s Survey.

¹⁶ For example, when describing the tender process, the CC’s Nature and Strength of Competition WP acknowledges that *“[t]he process is managed by the FD and the ACC, i.e. individuals with the knowledge and experience required to critically assess the bids submitted”* (paragraph 83).

¹⁷ See slide 46 of the CC’s Survey.

¹⁸ For example, see paragraph 88 of the CC’s Nature and Strength of Competition WP which says that *“Given [their] backgrounds, we consider that FDs and ACCs can be expected to have the professional knowledge and experience they require to monitor effectively in general terms the performance of the auditor. In addition, that ACCs tend to hold more than one AC position will give them the opportunity to compare the service provided to different FTSE 350 companies”*. See also paragraph 171 of the CC’s Evidence relating to the Selection Process.

¹⁹ Paragraph 27 of the Company I case study.

- (i) We monitor our clients extremely closely in order to be able to react to any emerging client dissatisfaction with the audit.²⁰ In particular, we have developed our Audit Relationship Risk Diagnostic²¹ [§<].²² In total, and based on the lead partners' perspective, [§<] of the companies we audit were judged to be subject to high or medium risk factors.²³
- (ii) That large companies are capable of using the threat of tender effectively, so as to achieve good quality and value for money audit services, is demonstrated by the market outcomes. There is no evidence of high prices or profitability.²⁴

9 The question is whether auditors feel they can neglect to provide a competitive service without facing a tender - the evidence against such a supposition is overwhelming.²⁵

The suggested infrequency of switching does not contradict active competition

10 The Competitive Strategies WP states that “[o]ur view of the MFQs and various submissions made by the parties indicate that the parties believe that there is active competition within the market and that they each actively compete, but that this competition does not necessarily translate into frequent switching of audit firms.”²⁶ [emphasis added] We object to this statement on two fronts:

- (a) It is not merely our belief that there is active competition within the market. Rather, this is the reality of the market and the conclusion follows from the CC’s observations of the market summarised in paragraph 4 above.
- (b) We disagree with any suggestion that switching is infrequent. Informed sophisticated buyers switch as frequently as they consider appropriate to secure competitive outcomes.

11 As regards the frequency of switching, we make the following comments:²⁷

- (a) Companies recognise that there are benefits of enhanced quality that are accrued from the knowledge and experience gained over time by the existing auditor.²⁸ This makes

²⁰ See paragraphs 2.67, 4.44 and 4.45 of our Initial Submission which outlines the processes utilised for this purpose, such as Client Perspective Reports, Independent Senior Partner Reviews and Client Satisfaction Surveys.

²¹ [§<]

²² [§<]

²³ [§<]

²⁴ [§<]

²⁴ See paragraph 6 above which explains how companies have been able to obtain reductions in price in recent years. Moreover, evidence on profits, as set out in our Observations on the Assessment of Audit Profitability (submitted to the CC on 7 August 2012), shows that the returns we generate on audits are consistent with what would be expected in a competitive market.

²⁵ See, for example, the Company G case study where the Group Financial Controller said that the “trigger points for a tender would be a slip in independence, skills or value for money” (paragraph 22). The ACC of Company H stated that it formally assessed auditor performance annually and that “EY was not in place for ten years irrespective of its performance. Reappointment was not taken for granted and the Audit Committee was ‘on their case’” (paragraphs 14 and 65). See also paragraphs 5.23 and 1.32 of our Initial Submission referring to the informal information available through the network of AC members and FDs who regularly move between companies (or have board roles in several companies simultaneously) and are able to judge the performance of auditors and their value proposition through first-hand experience. Also, the CC’s Survey shows that companies would seriously consider changing their auditors if there were signs of complacency (slides 68 and 74).

²⁶ Paragraph 3.

²⁷ We elaborate on these arguments in our response to the Nature and Strength of Competition WP.

²⁸ See our response to question 79 of the CC’s Markets and Financial Questionnaire (our **MFQ Response**) [§<].

them reluctant to lose this knowledge and experience and provides them with a greater incentive to exert pressure on their current auditor to ensure that they receive a high quality service on competitive terms.²⁹ In fact, the suggested infrequency of switching is explained by the CC's Survey which shows that the vast majority of companies do not tender because they are satisfied with the service they receive.³⁰

- (b) That companies face switching costs (including the investments companies have to make in building the knowledge of the auditor, holding tender processes and increased risk associated with new auditors), means that, if possible, they might prefer to achieve competitive outcomes from their existing audit firm. Their success in doing so (as shown by the significant reductions in price that non-switching companies have achieved in recent year, together with how the profitability of our FTSE 350 audit engagements do not depend on the tenure of these engagements)³¹ demonstrates that undue emphasis should not be given to the frequency of switching as a means of demonstrating active competition.
- (c) Notwithstanding the benefits of continuity and the switching costs that may be involved, it is clear that companies will tender and switch if they feel their auditor is complacent,³² or if they are persuaded that the benefits of switching outweigh the switching costs.³³

The Competitive Strategies WP materially downplays the significance of efforts to manage customer relationships and target rival firms' clients

- 12 We (and it appears other firms) have provided a significant body of evidence to the CC in this respect (as shown by the content of the Annex to the Competitive Strategies WP),³⁴ which is supported by the evidence available in the case studies and the CC's Survey, and consistent with the available data on pricing and profitability.³⁵ The critical importance of the activities audit firms undertake to retain existing business and to position themselves to succeed in tenders is understated in the Competitive Strategies WP.
- 13 Tenders necessarily cannot be repeated by companies on a frequent basis due to the costs and disruption involved. However, as explained above, experienced and sophisticated purchasers

²⁹ See for example, the Fund Accounting Manager in the Company J case study who stated that "*if [the current auditor] was doing a good job then there was no reason to switch*" and that the company's preference would be to "*stay with an audit firm providing a good service rather than take the risk of switching*" (paragraph 17).

³⁰ See slide 60 of the CC's Survey (as mentioned in footnote 9 above) where it is apparent that the sum total of the positive unprompted responses for not having tendered the audit cited in this slide comes to 133%, as compared with a sum total of 29% negative unprompted reasons. The positive reasons amount to 133% cumulatively being: (i) high quality service; (ii) good value for money; (iii) happy as things are; (iv) partner rotation keeps things fresh; (v) for continuity / familiarity; (vi) incumbent understands business; and (vii) benchmarking suggests get good value. The negative reasons (disruption and cost) amounted to only 29% cumulatively. We have categorised one response - time not right - as neutral (i.e. neither positive nor negative). This response accounted for 10% of the cumulative 173% of responses given. See also See our responses to the Survey WP and the Nature and Strength of Competition WP for further discussion of the CC's misrepresentation of the statistics in slide 60.

³¹ See Figure 11 in our Initial Submission.

³² See CC's Survey, slides 68 and 74 which confirm that 94% of ACCs and 88% of FDs would be very likely or likely to tender were the company's auditor to act complacently.

³³ See our response to the Switching Costs WP for more detail in this respect.

³⁴ That audit firms actively target their rivals' clients is indeed acknowledged by the CC in the Nature and Strength WP (see paragraph 155).

³⁵ For example, that non-switching companies have obtained significant price reductions in recent years, and the lack of relationship between the profitability of our FTSE 350 audit engagements and the tenure of these engagements.

such as ACCs and FDs are able to look to a variety of sources to judge whether they are receiving a competitive service and when it may be appropriate to tender. Audit firms respond to this by trying to protect their existing relationships and disrupt those of their rivals - this is the reality of day-to-day competition. If a tender takes place, this is because the existing auditor has failed to persuade the client of its merits, or the rival firms have persuaded the company, or the company itself has decided, that the benefits of tendering outweigh the costs (a judgement which inevitably involves reflection on the current level of service being provided). In the event of a tender, the Survey Results working paper reports that the existing audit firm stands only a 21% chance of being re-appointed.³⁶

- 14 In this respect, the Competitive Strategies WP correctly links the importance of building relationships³⁷ with the ability of firms to compete successfully in tenders by (i) increasing the company's awareness of the firm's capabilities; and (ii) increasing the firm's understanding of the company's audit requirements to allow it to perform well in any tender. The Competitive Strategies WP also correctly identifies non-audit services as a way of building relationships with companies.³⁸ However, the CC does not then draw the appropriate conclusion that these efforts to position a firm with the aim of prompting, and then succeeding in, a tender demonstrate strong competition.
- 15 It is notable that the mid-tier firms are significantly less active than the four largest firms in building these relationships in the FTSE 350,³⁹ and hence less aware when tenders are likely to arise. We disagree that "*firms as a whole did not generally receive advance warning of a tender*".⁴⁰ In fact, the four largest firms (and certainly PwC) often reported receiving indications of a possible tender if they knew the company.⁴¹ Receiving such indications is a consequence of the efforts made to build relationships and indicative of the recognition by the large firms that they need to monitor the market continuously for competitive opportunities.
- 16 The Competitive Strategies WP highlights that firms did not make "*unsolicited approaches to new clients on a frequent basis*".⁴² This is demonstrably wrong: as above, 88% of companies receive such approaches every two to three years.⁴³ It is these approaches which are the manifestation of the targeting programmes operated by the audit firms. We disagree with any inference that a lack of "cold bids" can be construed as a lack of competition - it is simply recognised by the audit firms that this is an approach that is unlikely to be successful. The reason for this is that the bespoke audit service requirements of a large company are highly complex, as recognised by both the sellers and sophisticated buyers in the market, which makes it extremely difficult for a firm to prepare a bid "cold" without some discussion to help it

³⁶ CC Survey Results WP, paragraph 49.

³⁷ Paragraphs 18 to 20.

³⁸ Paragraph 22. For example, we note that Grant Thornton stated in their response to the Issues Statement (12 January 2012) (paragraph 5.1) that they provide non-audit services to 36 FTSE 100 and 66 FTSE 250 companies (i.e. a significantly higher level of penetration than in relation to audit services). Also our client feedback, as referred to in section 4 of our Initial Submission, shows that positioning through non-audit services can be critical to securing audit appointments.

³⁹ CC's Survey, slide 82.

⁴⁰ Paragraph 25.

⁴¹ See paragraphs 36-38 of the Selection Process WP.

⁴² Paragraph 26.

⁴³ CC's Survey, slide 46.

better understand the scope and details of the company. However, cold bids may be one of the options for firms to build relationships and increase their understanding of companies.

- 17 The Competitive Strategies WP does not describe in any detail or give appropriate weight to the targeting programmes of the audit firms. These demonstrate the competitive intent of the various firms outside tender processes. Our own submissions regarding our *Tanks on Lawns*,⁴⁴ *Net 635*,⁴⁵ and other programmes describe initiatives specifically targeted at building market share by destabilising the existing audit relationships of our rivals⁴⁶ and the success of these initiatives.⁴⁷
- 18 Similarly, although the Competitive Strategies WP acknowledges that the firms “*each operate several strategies for managing client relationships*”,⁴⁸ we feel insufficient weight is placed on the importance and extent of these activities (for example, our own Client Perspective Reports, Independent Senior Partner Reviews, Post Decision Reviews, Audit Relationship Risk Diagnostic etc⁴⁹). These activities reflect our continuous concern to ensure we are offering our clients a competitive service to ward off the threat of tenders that our rivals are consistently seeking to trigger.
- 19 Furthermore, the Competitive Strategies WP fails to note that in order to retain and improve market position, an audit firm must continuously replenish its market share by targeting other FTSE 350 audits in addition to the audits of likely new entrants to the FTSE 350. The Competitive Strategies WP fails to take account of dynamics of the market in this respect. As previously set out,⁵⁰ there is significant “churn” of companies entering and exiting the FTSE 350 requiring audit firms to make considerable efforts to retain (or increase) market share by competing to win audits for companies that enter (or have the potential to enter) the FTSE 350 as well as the audits of companies switching within the FTSE 350.⁵¹
- 20 The points above, looked at in the round, show effective competition between the large audit firms who are under placed constant pressure to perform by large, sophisticated and experienced purchasers. This reality is not made clear in the Competitive Strategies WP. This feeds into the CC’s initial views in the Nature and Strength of Competition WP, which consequently understates the extent of competition outside tenders and the efforts made by firms through their strategies to try to win each other’s clients.

PricewaterhouseCoopers LLP

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⁴⁴ This programme involves targeting the audits of a small number of high-profile companies with the aim of growing the audit practice through winning “brand-defining” audit clients. See paragraphs 4.31 to 4.34 of our Initial Submission.

⁴⁵ The objective of this initiative is to achieve an increase in audit revenues from new clients by £[redacted].

⁴⁶ A selected list of companies within the FTSE 350 has been identified for targeting by a “shadow team”, which is monitored regularly by the Assurance Executive. Targets currently include: [redacted]. Furthermore, the Assurance Executive regularly assesses progress with regard to top tier targets and wins. [redacted]

⁴⁷ See Section 4C of our Initial Submission setting out details on these initiatives.

⁴⁸ Paragraph 31.

⁴⁹ As described in detail in our Initial Submission at paragraph 2.67.

⁵⁰ See our Initial Submission, paragraphs 4.4 to 4.23.

⁵¹ This churn is shown in detail in the infographic available on the PwC website at <http://www.pwc.co.uk/who-we-are/the-uk-statutory-audit-market-infographic.jhtml>.

ANNEX

We set out below our views on key points raised in the Competitive Strategies WP, with cross references to where we have addressed particular issues in previous submissions or evidence. We do not attempt to respond exhaustively to every comment made in the Competitive Strategies WP, particularly in the light of certain aspects being more fully considered in other working papers.

1 Revenue, Pricing and Margins

- 1.1 **Paragraph 8:** We disagree with the statement that it is only the parties' "view" that they face pricing pressure from companies.⁵² The data shows the existence of this pressure unequivocally - both inside and outside tenders. Non-switching companies have obtained significant price reductions in recent years and there is no relationship between the profitability of our FTSE 350 engagements and the tenure of these engagements. According to the Competitive Strategies WP, the frequency of the threat to tender if fees are not reduced and the likelihood of a client following through are not apparent. This is not our experience: as explained above in paragraph 8, notwithstanding the incentive for companies not to lose the benefit of the knowledge and experience accrued over time by their current auditor, if the auditor fails to deliver on the required level of quality or price, companies can and will put the audit contract out to tender and we are well aware of this possibility.
- 1.2 **Paragraph 9:** We believe the fact that audit firms seek additional revenues through winning new clients and - in the face of resistance to price increases from experienced purchasers - by emphasising cost reductions and efficiencies to maintain margins is clear evidence of an effectively functioning competitive market.
- 1.3 **Paragraph 10:** We are identified in the Competitive Strategies WP as the only firm which explicitly includes increasing prices as an element of our firm-wide financial strategy (alongside increasing revenue by increasing our market share). It is not clear to us why this is highlighted as this is one element of a firm-wide strategy (and is not part of the audit-specific strategy),⁵³ and such a strategy is in common with many other businesses - including other audit firms even if this is not explicit. The need for such a strategy is clear as we respond to the pricing pressure we face from clients which has resulted in fees being pushed down. As illustrated by Figure 10 in our Initial Submission, we experience significant pricing pressure in annual fee negotiations.⁵⁴ Indeed, the CC's descriptive statistics show that companies have been successful in driving down audit fees.⁵⁵ While striving to increase price is a key part of our strategy, in this context, the evidence shows we will not necessarily be successful.
- 1.4 **Paragraphs 12-14:** The Competitive Strategies WP also sets out that there is a perception by mid-tier firms of "low-balling" and that the four largest firms attempt to enter the market for smaller companies by undertaking work at close to cost price. We have seen no evidence to

⁵² See paragraph 6 above.

⁵³ See Q24 of our MFQ Response [3<].

⁵⁴ [3<]

⁵⁵ The CC's analysis shows that companies have been successful in driving down audit fees; average auditor hours per engagement have remained broadly static from 2006 to 2011, while average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms). See paragraph 35 of the CC's working paper on Descriptive Statistics and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - "Engagement Data Descriptive Statistics - PwC).

support the suggestion that the four largest firms “low-ball” in order to win audits in competition with smaller firms. Indeed the “perception” that mid-tier firms have that “*the Big 4 attempt to enter the market for smaller companies, undertaking work at close to cost price*” is not supported by fact:

- (a) The four largest firms are already present - and have significant market shares - with regard to all listed and large private companies. As the CC’s Survey shows, non-FTSE 350 companies frequently prefer the four largest firms⁵⁶ so it is wrong to characterise the four largest firms as trying to “enter” this market. If the mid-tier are referring to companies even smaller than this, it is not clear to us what sector of the market it is that the four largest firms would be seeking to enter, but it would certainly not be companies which have any realistic short or medium term aspirations to enter the FTSE 350.
 - (b) In any audit tender, our bid will aim to be competitive in terms of quality and price, taking into account the likely competitive offerings of those firms with which we are in competition. To the extent that mid-tier firms have been invited to tender presumably the company considers that prima facie they are capable of delivering the audit. In such circumstances, we would seek to emphasise our attributes, in terms of experience, technical and sector knowledge and international coverage, and offer a price that reflects a range of factors. These would include the nature of the company and the audit engagement, our utilisation of available capacity at the time in question, and our views on what the likely competitive levels of bid will be. In doing this, we are conscious of covering our direct costs in providing the service and of generating as great a contribution to indirect costs and profits as we can. It is this competition which drives price down - and if the result is close to cost pricing, this is an outcome which is entirely consistent with a competitive market. We note that the evidence from companies on the reasons why mid-tier firms are not successful are primarily linked to quality-related factors, rather than price.⁵⁷
- 1.5 We also do not agree with the perception of low-balling taking place in off-peak periods. All firms have seasonal demands and times of under-utilisation. The appropriate commercial strategy may therefore be to charge more for companies with year-ends at the end of the calendar year, as this is most common and drives peak capacity needs, and accept lower pricing in quieter months (i.e. clients with an August year end may obtain a cheaper audit than a December year end). However, this makes commercial sense and reflects the economics of the business and is not strategically aimed at targeting mid-tier audit firms.
- 1.6 **Paragraph 16:** The CC refers to firms maintaining and growing profit margins. There is no evidence to support this comment. Our submission on the assessment of audit profitability showed that over the period 2007 to 2011 our gross profit margin fell from [x] to [y] and our economic profit margin fell from [z] to [w] over the last 5 years.⁵⁸

⁵⁶ 85% of Non-FTSE 350 companies use one of the four largest firms for their audit and 46% of non-FTSE 350 firms said they only invited the four largest firms to tender (see slides 16 and 54 of the CC’s Survey).

⁵⁷ See slide 85 of the CC Survey which shows that, of those who would not formally consider mid-tier firms, 69% of ACCs and 59% of FDs/CFOs cited “*size of audit firm and geographical coverage*” as the reason and 45% of ACCs and 27% of FDs/CFOs cited “*sector specific knowledge/experience*”.

⁵⁸ See Table 1 of our Observations on the Assessment of Audit Profitability (submitted to the CC on 7 August 2012).

- 1.7 We agree that we have been making cost efficiencies in audit methodologies which help to lower resource requirements.⁵⁹ However, this understates the other efforts we have been making to improve efficiency across our entire cost base, including across the range of support functions. For example, we have been creating efficiencies in training costs through remote learning techniques and savings in travel costs through greater use of video/audio conferencing technologies. We have also invested in IT tools and sourcing models to enable us to deliver a consistent and efficient high-quality audit service while controlling cost.⁶⁰

2 Attracting and retaining clients

- 2.1 **Paragraphs 18 - 20:** As discussed above, in paragraphs 12 to 20 in our response, we agree that firms seek to win work from new clients and that building relationships with clients pre-tender is critical to the ability to do this, for both the reasons given by the CC (i.e. to make the firm (and potentially an audit team known to the target company) and to allow the firm to develop its own knowledge of the company's operations and business risks for use in a subsequent tender). We note the mid-tier have distinct and less ambitious strategies than the four largest firms, and believe this is both reflected in their market performance and indicative of their real view on their capability to compete successfully in the FTSE 350 audit market, given their attributes compared with those of the four largest audit firms. However, this it is not clear to us why the CC's recognition of firms' efforts to win clients is not given weight in the CC's view that companies lack the information to make informed decisions outside tenders.⁶¹
- 2.2 **Paragraph 21:** As the CC's Survey shows, the knowledge and expertise of the lead partner and the wider audit team is critical to success in tenders.⁶² We agree that we have a competitive advantage as a consequence of the experience and expertise of our auditors, partly as a consequence of their industry knowledge, gained over many years.
- 2.3 **Paragraph 22:** The CC acknowledges that firms unable to demonstrate sector credentials through previous audit work can use non-audit work as a way of developing a professional relationship. We agree with this, and note that the mid-tier have referred to the fact they carry out non-audit work for many FTSE100 companies which gives them an opportunity to build relationships with these companies.⁶³
- 2.4 **Paragraph 25:** On the subject of potential tender "*trigger points*", the CC mentions change in key staff as being such an event, but the focus is on new ACCs or FDs. The CC fails to consider the rotation of lead audit partners which must also be taken into account as one of the key events when a company reflects on its current audit service. Even where the company is otherwise satisfied with the level of service provided, given that the most important consideration for large companies when appointing an audit firm is the experience and knowledge of the engagement partner, it follows that the change in the lead audit partner often

⁵⁹ See Annex 6 to our Initial Submission.

⁶⁰ These programmes were described in detail in Annex 6 to our Initial Submission, including the Aura audit support IT tool and the Global Assurance Delivery Model (a sourcing model designed to reallocate certain administrative and common audit procedures to overseas centres with the aim of enhancing quality, improving efficiency and flexibility and controlling cost of delivery).

⁶¹ See, for example, paragraph 141 of the Nature and Strength of Competition WP.

⁶² See slide 33 of the CC's Survey: 92% of FTSE 350 companies cited "*Experience and knowledge of engagement partner*" and 82% cited "*Experience and knowledge of engagement team*" as important factors when deciding to (re)appoint an audit firm.

⁶³ For example, see Grant Thornton's response to the Issues Statement (12 January 2012) where in paragraph 5.1 they state that in the year ended December 2011, Grant Thornton provided non-audit services to 36 FTSE 100 and 66 FTSE 250 companies (i.e. a significantly higher level of penetration than in relation to audit services).

raises the question of whether it might be appropriate for the company to put the audit out to tender.⁶⁴

- 2.5 **Paragraph 26:** The Competitive Strategies WP does not accurately reflect the frequency of unsolicited approaches taking place. We believe this is because the CC characterises “*unsolicited approaches*” as formal “*cold bids*” - i.e., submission to a company of an audit proposal uninformed by prior discussion of the company’s needs and audit scope. Such a characterisation is misleading. As we have described above,⁶⁵ we regularly approach clients (current and potential) to develop existing relationships and build on our understanding of their business,⁶⁶ but we rarely submit formal “*cold bids*” for the simple reason that these are not effective without some prior discussion with a company of its requirements.
- 2.6 Informal contacts are, however, specifically intended to demonstrate our credentials and encourage a company to carry out a tender. With some target clients we go further and use a “*shadow team*” to establish a good relationship with the company to allow us to make a proposal credible on a particular “*trigger point*” (such as when the existing lead audit partner rotates; on a change to the board or audit committee; or on a merger or acquisition).
- 2.7 Paragraph 26 states that, where a tender exercise has taken place shortly after an unsolicited bid, it is not clear whether the bid had the effect of prompting the tender. This is also our experience: the effect of such an unsolicited bid will depend on the circumstances. However, our general view is that better results are achieved by building a relationship and understanding of a company’s business than by submitting entirely “*cold*” bids.
- 2.8 **Paragraph 29:** The CC states that it is not clear how many shadow teams a partner or other staff may be associated with and how many are in place across the firms. It is not possible to give statistics on shadow team numbers or the extent of our partner and staff involvement as targeting responsibility is primarily given to business units and oversight is focussed on the *Net 635* results. Most partners have targeting and relationship building objectives, although the extent of these vary depending on individuals’ roles. Targeting activities range from having a comprehensive shadow team in cases where there is judged to be a prospect of prompting a tender, or a company is highly attractive as an audit client in the longer term (as was [X]), to less structured relationship development or maintenance when the prospect is less clear.
- 2.9 Typically shadow teams are active on around five companies in and around the FTSE 100 at any time with a larger number in the FTSE 250 (albeit with smaller teams). [X] We are continuously monitoring the status of each FTSE 350 company and reassessing our targeting plans.
- 2.10 **Paragraph 31:** Only formal feedback is referred to by the CC and, in particular, the use of annual surveys and interviews with clients on the conclusion of an audit. This significantly under-represents the extent of feedback that we seek from clients and the monitoring that we

⁶⁴ See slide 79 of the CC’s Survey which cites “*Rotation of Audit Partner*” as a trigger for a FTSE 350 company to seriously consider changing its audit firm. See also our Initial Submission, paragraphs 5.24 to 5.26, for more information on the challenges associated with the rotation of the lead audit partner.

⁶⁵ See paragraph 8(b)(ii).

⁶⁶ Indeed, the regularity of such informal contacts across the market is confirmed by the CC’s Survey which found that 78% of FTSE 350 companies have informal contact with other auditors outside a tender process (slide 46).

undertake of our audit relationships to ensure that our service is meeting expectations and is competitive given the high levels of interaction that companies have with other audit firms.⁶⁷

3 Services offered

- 3.1 **Paragraph 34:** We agree that all firms offer non-audit services to their clients - the firms are all multi-disciplinary in nature. However, the CC ignores the clear trend from the engagement data that the level of non-audit fees offered to audit clients has been in decline in recent years.⁶⁸
- 3.2 **Paragraph 35:** In addition to the differentiation by breadth of services, the main differentiation between the large firms and the mid-tier is in the greater expertise and experience that can be offered by the larger firms. As the CC's Survey confirms, expertise and experience are among the most valued characteristics in auditors,⁶⁹ and we believe this is also the case in relation to the other professional services we offer. This in turn affects audit quality, as our specialists in non-audit services are available to provide expert assistance on our audits as required.

4 People

- 4.1 **Paragraphs 36 - 41:** We have been consistent in our submissions that investment in recruitment and retention of talented individuals is central to our business model. We covered the efforts and investments we make in this respect in some detail in our Initial Submission.⁷⁰
- 4.2 We note that the "*data provided by the Big 4 indicates little movement of staff and partners from their firms to mid-tier firms*" and that "*partners targeted for recruitment by the mid-tier were those who had achieved a level of seniority but who were unlikely to progress further in their current firm*" (**paragraph 38**). This is consistent with the higher levels of remuneration, better career opportunities and stronger client portfolios on offer at the four largest firms. The mid-tier explicitly acknowledges this in **paragraph 37**.
- 4.3 **Paragraph 41:** We note the CC highlights an example of innovative recruiting by Grant Thornton. We have also taken innovative approaches in recruiting,⁷¹ and would reject any suggestion that the mid-tier firms are more innovative in this respect than other firms. We are very proud of our record in attracting graduates to apply to join PwC, through our extensive involvement in recruitment fairs, undergraduate events and other approaches and were recently voted the top graduate employer for a record-breaking ninth consecutive year.⁷²

⁶⁷ See paragraphs 8(c) and 18 above of this response to the Competition Strategies WP.

⁶⁸ Figure 8 of the CC's Working Paper on Descriptive Statistics.

⁶⁹ See paragraph 35 of the Survey Results Working Paper.

⁷⁰ See paragraphs 3.18 and 3.19 of our Initial Submission.

⁷¹ For example, our University Partner Programme with Newcastle University ("Flying Start") provides some 50 undergraduates each year with the opportunity to study for a degree, to qualify towards their ICAEW and to have business placements with us. Similarly, our Professional School Leavers programme allows 100 students to join straight from school and study towards their ICAEW qualification in four years.

⁷² PwC was voted number one in The Times Top 100 Graduate Employer award in 2012 for the ninth consecutive year. The Top 100 rankings were compiled from face-to-face interviews conducted by High Fliers Research with 17,737 final year students who graduated from UK universities in the summer of 2012. They were asked the open-ended question "Which employer do you think offers the best opportunities for graduates?"

5 Reputation and brand

- 5.1 **Paragraph 42:** It is not clear why Grant Thornton's "*active development*" of thought leadership merits particular attention. We spend a considerable amount of time on thought leadership⁷³ and consider that the thought leadership offered by us and the other large firms, as a consequence of our experience and expertise, is of more relevance to potential FTSE 350 audit clients than that offered by mid-tier firms which have less relevant direct experience.

⁷³ See paragraphs 26.24 - 26.27 in Q26 of our MFQ Response [3<].