22 March 2013

Laura Carstensen, Chairman of the Audit Investigation Group
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Dear Ms Carstensen

Statutory Audit Services for Large Companies Market Inquiry - response to Provisional Findings (PF) and Remedies Notice (RN)

We welcome the opportunity to re-engage with the Competition Commission (CC) at this crucial stage of your investigation into the future of the large company audit market in the UK.

We believe that audit plays a critical role in the effective functioning of the capital markets by building trust between companies and their shareholders and underpinning the delivery of reliable, relevant and timely information to them about the organisation in which they have invested. We have always been and remain absolutely clear that we work for the shareholders of the company. The investor base of most large companies is widespread and constantly changing and that makes day to day communication with each of them near impossible. Audit committees (ACs) play a crucial role providing oversight of the audit on behalf of the investors.

Independent regulators play a key role in underpinning the reliability and relevance of company reporting and auditing. The audit, and governance around the audit, has responded to changing needs. That process continues as illustrated by the adoption in September 2012, after extensive consultation with all market participants, of changes to the Financial Reporting Council's (FRC's) UK Corporate Governance Code (the Code) to include a provision reiterating the importance of regular competitive tendering of the audit contract at least every ten years on a comply or explain basis.

PwC is determined to respond positively to changing needs and opportunities to further improve the effectiveness of the governance regime.

While we do not agree with the PFs that there are features of the large company audit market that lead to adverse effects on competition (AECs), we believe that there is an opportunity to introduce a package of remedies that:

- promote competition and choice;
- enhance audit quality and innovation;
- increase transparency between auditors, ACs and shareholders; and
- do not impose a disproportionate burden on companies or firms or give rise to adverse consequences for competition, quality or accountability.

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We believe that the following package of remedies, which is based on many of those raised by the CC and provides an additional suggestion in relation to transparency, would make a significant positive impact on the large company audit market. We have also addressed those remedies raised by the CC which we do not support because they do not achieve the desired goals and, in our view, would be detrimental to choice, quality and innovation, would be disproportionate and would be damaging to the large company audit market. These include mandatory rotation and mandatory tendering.

Audit tendering under the Code

- We support the new FRC tendering regime which will make a very material change to the number of tenders taking place among FTSE 350 companies, with the average number increasing from about eight to ten a year to 35 a year. We agree with the FRC that this new regime should be given an opportunity to work before being dismissed as inadequate.

Strengthened accountability of the external auditor to the AC

- The AC should be promoted and reinforced as being responsible for managing the tender process and the relationship with the auditor. This will ensure that audit firms are incentivised to compete to provide a high quality and innovative service that is valued by shareholders.

- We support measures to increase the standing and recognition of the AC among the investor community such as expanding the range of issues that should be discussed by the auditor with the AC; ensuring that management and shareholders understand that the AC is primarily responsible for the appointment and oversight of the auditor; and increasing the AC's visibility (through expanding the content of the AC's report and the role of the AC at General Meetings).

Enhanced shareholder-auditor engagement

- The level of transparency between the auditor, ACs and shareholders should be increased. In addition to strengthening the auditor's accountability to the AC, we support increasing auditor engagement directly with shareholders and extending the reporting requirements of audit matters.

The role of the FRC

- It is important to maintain the independence of the regulatory regime. Therefore it should be for the FRC to establish the appropriate scope of work that it should perform as part of its quality assurance activities. However, we believe that the FRC's remit could be expanded and refined to review more audits each year.

Greater transparency of audit quality

- We propose that all audit firms should be encouraged to disclose information in their annual transparency reports to assist companies (specifically ACs) in comparing the quality of competing audit firms. Such information might include, as we already currently provide in our annual transparency reports: results of the FRC's Audit Quality Review Team (AQRT) 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.

"Big 4 only" clauses

- Any artificial barriers to selection that other audit firms might face, such as certain loan agreement templates that contain "Big 4 only" clauses, should be removed.

It is also important that the package of remedies should be viewed holistically and not considered as individual isolated components. For example:

- empowering shareholders to take a more active interest in the audit, coupled with the enhanced role of the AC, where the Audit Committee Chair (ACC) can be expected to take a more visible shareholder-facing role, underpins the new provision in the code whereby ACs are incentivised to put audits out to tender on a regular basis;

- shareholder empowerment will inform the AC as they make auditor appointment decisions and encourage greater transparency around the process; and

- when reviewing their existing auditor and evaluating alternative firms, the AC will have access to additional information about audit quality from the AQRT as well as from audit firms.

We are very concerned that certain measures that have been included in the RN will not meet the objectives set out above and will give rise to adverse consequences for competition by reducing choice and imposing a disproportionate burden on companies or firms. In particular:

Mandatory rotation

We agree with the FRC that mandatory rotation would reduce choice and have an adverse effect on audit quality.

The introduction of mandatory rotation in any form would force a company to change its auditor and would deprive it of its right to make an informed choice whilst imposing costs and increasing audit risk. Because it would be forced to change, it could be faced with having to appoint an auditor that it judged would not be able to provide either the quality or cost efficiency of the existing firm. By way of illustration of the potential disruption, if mandatory rotation were required every seven years the company would face significant audit and business disruption in six of the next ten years (with the year of the tender followed by two years of a new auditor becoming familiar with the business, with the cycle repeated again in only four years time).

Such an extreme intrusion into the affairs of large companies could only be justified by compelling evidence that it is necessary to address a serious AEC and detrimental effects, and that there is no less onerous measure that could achieve this. The justification for such a remedy does not exist and there are alternatives that can resolve the AECs in a more proportionate way. The CC has conducted no analysis or modelling to justify why mandatory rotation would produce better outcomes for the market, relative to the increased costs imposed on companies and audit firms, and the reduction of choice imposed on companies.

Mandatory tendering every five or seven years on an "open book" basis

We have already referred to the introduction in September 2012 of new provisions to the Code, which will result in a significant increase in the level of tendering and the vast majority of companies tendering at least once every ten years. Given the extent of market consultation before that change was introduced we agree with the FRC's view expressed in their letter dated 18 March 2013 that this new provision "should be given time to take effect before further changes are made". In particular we would be concerned that a shorter maximum period than ten years would reduce the effectiveness and value of the tender process and would materially increase costs and disruption for companies and audit firms. We also support tendering on a "comply or explain" basis because forcing companies to tender the audit when faced with a crisis or other exceptional event is not in the best interests of the shareholders.

The imminent increase in tender activity will mean that all participants in the tender process will need to be more effective and efficient and therefore a focus on how to do that is important. However, an "open book" approach may have serious unintended consequences of compromising highly confidential company information; deterring audit firm innovation; and compromising the benefit of any "fresh approach" should the company decide to switch auditor. It should not be pursued.

Provisional Findings

Whilst we are supportive of certain remedies that would help further demonstrate effective competition, enhance quality and innovation and improve transparency, we do not accept the CC's provisional findings that there are features of the large company audit market that leads to AECs.

The CC's underlying assumption that auditors must *either* satisfy executive management *or* shareholders and, because executive management play an influential role in the appointment and oversight of the auditor, this must mean that auditors prefer to satisfy management rather than shareholder demand, is not supported by the evidence. It leads the CC to fundamentally mischaracterise the role of the auditor and fail to acknowledge the paramount duty that auditors owe to the company in the interests of shareholders.

Although the CC recognises that it is generally unrealistic to benchmark how the market is performing against the theoretical measure of a "perfectly competitive" market, this is indeed what the CC appears to have done in this inquiry. Occasional lapses of quality by auditors, the fact that some audits are more profitable than others and demands by some investors for the audit to evolve does not provide compelling evidence showing that the market is not functioning effectively. This is not an appropriate or justifiable benchmark.

Finally we believe that there are serious failures of due process in the CC's evaluation of primary facts. The CC acknowledges that its review of the evidence involved the application of judgement to a greater extent than in many market investigations, but it appears the CC has selectively used evidence in an unbalanced way to consistently reach findings that support the theories of harm rather than the conclusion that the market is functioning effectively.

We have set out in our detailed response which accompanies this letter a thorough argued case in relation to our comments on the Remedies Notice and the Provisional Findings. We look forward to engaging constructively with the CC over the next phase of this inquiry.

Yours sincerely

Richard Sexton

Executive Board Member – Reputation and Policy

For and on behalf of PricewaterhouseCoopers LLP