22 March 2013

Non-confidential version

Statutory Audit Services for Large Companies Market Inquiry

PwC's response to the Provisional Findings (PF) and Remedies Notice (RN)

1 Introduction and structure of this response

1.1 We explain in our letter of 22 March 2013 that accompanies this submission (our Response) that we wish to engage constructively with the Competition Commission (CC) in this phase of the investigation. We recognise that the audit market must continue to evolve to remain valued by the capital markets and we are actively engaged in ongoing initiatives to achieve this objective. We therefore welcome a package of measures that promote competition and choice; enhance audit quality and innovation; and increase transparency between auditors, audit committees (ACs) and shareholders; provided these measures are proportionate.

1.2 Although we recognise that there is scope to improve the large company audit market, we do not accept the CC's provisional findings that there are features of the market that lead to adverse effects on competition (AECs).

1.3 Our covering letter summarises our views on the PFs and the possible remedies. This Response sets out our views in more detail and is structured as follows:

Section 2: Fundamental concerns with the CC's approach and provisional findings

Section 3: Our views on the possible remedies identified by the CC in the RN

Annex 1: The paucity of evidence in the PFs of adverse outcomes which is particularly relevant to assessing the proportionality of possible remedies

Annex 2: Our position in respect of each of the features of the market identified in the PFs

Annex 3: Answers to the detailed questions set out in the RN.

2 Our fundamental concerns with the CC's approach

2.1 We have a number of fundamental concerns regarding the CC's approach in this market investigation as demonstrated in the PFs and the press release announcing the PFs, which we describe in the following sub-sections dealing with:

(a) the CC's underlying assumption that auditors are faced with a binary decision to satisfy either management or shareholder demand and select the former;

(b) the outcomes expected by the CC from the application of the "well-functioning market" test; and

(c) the CC's flawed approach to the evidence, which shows serious failures of due process in the evaluation of primary facts. This section is supplemented by Annex 1, where we explain that the evidence in respect of market outcomes does not support the CC's provisional findings.

2.2 In Annex 2 we summarise our position in respect of the features of the market identified by the CC.

The underlying assumption that auditors are faced with a binary decision to satisfy either management or shareholder demand and select the former

2.3 Auditors and directors owe legal and regulatory duties to act in the best interests of shareholders. However, the CC describes "principal-agent issues" arising from the relationship between shareholders, the board, executive management and auditors. The PFs conclude that these issues lead to auditors satisfying management demand, which may differ from shareholder demand. We do not accept this characterisation of competing demands and the implication that we (and directors of large companies) are not complying with our legal and regulatory duties.

2.4 The CC's approach is flawed by false certainty. It is wrong to characterise management and shareholder requirements of the audit as two distinct, easily separable and competing demands; then to analyse the relative incentives for audit firms to respond to each set of demands in a binary way; thereby reaching the conclusion that because executive management is influential in the appointment and retention of auditors, those audit firms must be - and therefore are - incentivised to respond to management rather than shareholder demands, such that competition is distorted as firms are competing on the wrong parameters[1].

2.5 This flawed underlying assumption has led the CC to (a) mischaracterise how auditors perform their role; and (b) fail to acknowledge the paramount duty that auditors owe to the company in the interests of shareholders. We address these two points below.

[1] We explain in more detail in paragraphs 6 to 8 of Annex 2 that the practical reality is that for an audit firm to win and retain an audit appointment for any large company, the position is not as the PFs suggest.

The mischaracterisation of how auditors perform their role

2.6 The PFs demonstrate a misunderstanding of the role of auditors. This is manifested by the inquiry chairman's statement in the CC's press release, that the CC desires to see a substantive change in the market so that the *"external audit becomes a more genuinely independent and challenging exercise where auditors are less like corporate advisors and more like examining inspectors"*[2]. This mischaracterisation is important because it goes to the heart of the problem that the remedies are designed to address. As we explain below, auditors are neither corporate advisers nor examining inspectors. The duties of the auditor are clearly prescribed and remedies designed to achieve a fundamental change to this role would be wholly inappropriate.

2.7 There is no evidence in the PFs to justify the statement that auditors act like corporate advisers. Corporate advisers are required to take instructions from the company management and perform their duties in accordance with those instructions. Even if one was to accept the conclusions in the PFs that auditors occasionally succumb to pressure to accommodate management's proposed accounting treatment (which, as we explain in the sub-section below, we do not accept) the market outcome that this is said to give rise to is that *"auditors have in recent years on occasion failed to demonstrate appropriate levels of professional scepticism"*[3]. There is no suggestion that pressure to accommodate management's accounting treatment leads to, or is caused by, auditors systematically undertaking a completely different role from that for which they are instructed and acting like corporate advisers. Any auditor who behaved in this way would be in fundamental breach of his or her legal and regulatory duties. There is no evidence in the PFs or elsewhere that this is the case.

2.8 The statement in the CC's press release appears to relate to a conclusion in the PFs that: *"…auditors have comprehensive legal rights of access to information and rights to require explanation. We consider that the auditors' emphasis on maintaining good relationships for the purpose of inquiry is unusual among investigative bodies that have access to such extensive powers."*[4] The implication being that a desire to maintain a good relationship undermines the ability of the audit firm to properly undertake its duties. In fact the reality is the opposite of this. Maintaining professional relationships with management within appropriate boundaries facilitates the exercise of the auditor's functions. A high reliance on the exercise of statutory powers would not be a sign of an effective audit but rather one where appropriate contact between the auditor and the company had broken down.

2.9 We are not aware of any evidence in the PFs or elsewhere that an emphasis on maintaining good relationships with the company is "*unusual among investigative bodies*". It may be that the reference to examining inspectors in the press release is to inspectors appointed under Part XIV of the Companies Act 1985 and that the CC sees such inspectors as the type of investigative body against which auditors should be benchmarked. Such Companies Act investigations are conducted when a serious allegation is made against a company and are similar to police investigations or investigations by competition authorities into alleged breaches of competition law. They are "one-off" investigations where a serious infringement is suspected.

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2 The CC's press release: "Audit market not serving shareholders" (February, 2013).
3 PFs at paragraph 11.104 (paragraph references from hereon will refer to the PFs, unless stated otherwise).
4 Paragraph 7.147.

It is wholly inappropriate to make a comparison between such proceedings and the role of auditors whose principal role is not to investigate a specific allegation of misconduct. To the extent that it is of any value to make a comparison between the role of an auditor and other bodies that have investigatory powers (which we doubt), a more appropriate comparator than company inspectors would be sector regulators who, like auditors, have wide investigative powers and must be ready, willing and able to take actions that are contrary to the interests of company management. Like auditors, they do not see this as inconsistent with maintaining a proper day-to-day relationship with the businesses they regulate in order to perform their duties effectively.

2.10 As Lord Denning said, for an auditor: "*[t]o perform this task [to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths] properly, he must come to it with an inquiring mind*…"[5]. However, this is not the same as performing an inspection or an investigation into suspected dishonestly, which is expressly not what an auditor is expected to do (Lord Denning went on to say "…- *not suspicious of dishonesty, I agree - but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none*")[6]. To perform an audit it is essential to understand the business; as the audit engagement partner (AEP) for Company A explained, to *"understand how a set of numbers were put together and what motivated the team who produced them"*[7]. This requires the auditor to have a professional working relationship with management[8].

2.11 This is recognised in International Standard on Auditing (UK and Ireland) 260 (ISA (UK&I) 260) which provides guidance on the role of communication and states that: *"effective two-way communication is important in assisting:*

(a) "*The auditor and <u>those charged with governance</u> in understanding matters related to the audit in context, and <u>in developing a constructive working relationship</u>. This relationship is developed while maintaining the auditor's independence and objectivity*";

(b) "*The auditor in obtaining from those charged with governance information relevant to the audit. For example, <u>those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events</u>*"; and

(c) "*Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements*."[9] [emphasis added]

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5 Paragraph 3.18.
6 Paragraph 3.18.
7 Paragraph 7.135.
8 Paragraph 7.135.
9 Section 4 of ISA (UK&I) 260: "Communication with those charged with governance" (15 December 2010) available at http://www.frc.org.uk/getattachment/25391af3-1620-4d04-9d3b-22bd64d16d2c/ISA-260-Communication-with-those-charged-with-governance.aspx

2.12 Maintaining such a relationship does not mean that auditors compromise their duty to the company (in the interests of the shareholders) to remain independent and exercise professional scepticism, as we explain next.

The paramount duty of auditors to the company (in the interests of the shareholders)

2.13 We challenge in the strongest terms the headline conclusion by the CC in the press release that the *"[a]udit market [is] not serving shareholders"*, there is a *"tendency for auditors to focus on satisfying management rather than shareholder needs"* and *"too often auditors' focus is on meeting the needs of senior management who are the key decision takers on whether to retain their services"*[10].

2.14 These statements are tantamount to a finding that we (and the other audit firms serving this market) are breaching our legal, professional and regulatory duties to provide reasonable assurance that the financial information presented by the company is true and fair. Although these statements are not supported by the evidence they are, as with the comment in respect of examining inspectors, indicative of the conclusions that the CC has purported to draw in the PFs and appear to underlie the CC's approach to some of the remedy proposals.

2.15 In the absence of hard evidence the PFs, in reaching their conclusion on scepticism and auditor independence, rely on speculation, supposition and innuendo. The conclusion is based on an underlying assumption that because financial directors (FDs) are influential in the appointment of an auditor (where the CC fails to give sufficient weight to evidence concerning the role of the AC), audit firms will act contrary to their duties to shareholders in order to satisfy the FD.

2.16 The CC's reasoning in this regard is explained in the Summary of the PFs, where the CC finds that *"while most of the time audits were performed diligently and with appropriate challenge, any loss of audit objectivity or scepticism in conducting a given audit would not be easily detectable, and so it was possible that such loss of independence occurred without being known to shareholders"*[11] [emphasis added]. However, the CC then goes on to provisionally find that *"the loss of independence arose because competition between audit firms was on the wrong parameters"*[12] [emphasis added]. The CC thus concludes that the problem (loss of objectivity) is hard to detect, so this must give rise to a possibility that the problem exists, which must mean there are times when it does exist and this is attributable to a competition concern. This definitive finding simply does not follow from the fact that it is possible that there may have been a loss of independence, which is unknown to shareholders.

2.17 This reliance on speculation rather than evidence is justified by the CC because: *"Any loss of independence on any given engagement …will only be apparent to those directly involved in the process (ie the FD, the AEP and their respective teams, and, in circumstances where the issue has been escalated, to the ACC)…"*[13].

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10 See footnote 2.
11 Summary of the PFs, paragraph 28.
12 Summary of the PFs, paragraph 28.
13 Paragraph 11.101.

2.18 Strong evidence that points to an alternative conclusion on auditor scepticism is materially discounted. Thus:

(a) The CC correctly explains in the PFs that while accepting that good relationships are compatible with a thorough investigation, "*for any audit firm, it has both a financial interest in maintaining its relationship (and the associated income) and a countervailing interest in maintaining its reputation for integrity…, since losing that reputation would invalidate its opinion and its livelihood*"[14][emphasis added]. This is a fair description of the influences facing an audit firm and the overwhelming reason why no auditor would compromise his or her integrity. Yet the CC proceeds to reach a provisional finding that audit firms have "*strong incentives to provide the service that FDs demand, even if such demands do not align with those of shareholders*"[15].

(b) Clear evidence has been provided regarding how we are obliged to and do challenge the preferred accounting treatment of management, yet the CC ignores this evidence in the PFs. For example:

(i) As part of our obligations, we are required under paragraph 16(a) of ISA (UK&I) 260 to communicate "*significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity*."

(ii) When we asked our FTSE 350 audit partners, they reported that in the last five years the large majority (77%) 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%).[16]

(iii) The CC has ignored evidence from its case studies regarding the exercise of professional scepticism. For instance, [✂] demonstrated clear challenge to management. (For the avoidance of doubt, both issues were raised by the AEP with the ACC.)

(c) The PFs acknowledge that ACs are *"an important and, by and large, powerful force in directing audit firms towards satisfying the demands of shareholders"*[17] but nevertheless are found to be unable to protect shareholders.

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14 Paragraph 5.47.

15 Paragraph 11.94.

16 See our response to Certain Third Parties' Submissions (6 July 2012), paragraph 2.13: 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% of companies, with 96% of such conversations resulting in management changing its approach to an accounting, disclosure, or control issue.

17 Paragraph 11.98.

(i) This is not based on any evidence of failure by ACs but is instead supposition - based, in particular, on the influential role of the FD.

(ii) The CC ignores the clear results of its follow-up survey and is selective of evidence from Professor Vivien Beattie - see paragraphs 2.37 and 2.38 below.

2.19 The PFs suggest that the findings on limited auditor scepticism are consistent with the evidence on market outcomes in two respects:

(a) *"The concerns raised by the FRC and AQRT…that auditors have in recent years on occasion failed to demonstrate appropriate levels of professional scepticism"*[18]: However, we do not accept the only two specific examples of our alleged failure to demonstrate appropriate levels of professional scepticism[19]. In any event, "occasional" failures in maintaining standards (although regrettable) cannot be taken as evidence of a wider market problem let alone a problem attributable to inappropriate parameters of competition rather than some other cause as the Summary of the PFs makes clear *"most of the time audits were performed diligently and with appropriate challenge"*[20], and

(b) *"[T]he failure of auditors to identify the impending financial collapse of some large companies"*[21]: In fact, the PFs contain no conclusion that auditors failed in their responsibilities in not identifying the impending financial collapse of large companies because of inadequate levels of scepticism or because their incentives were otherwise distorted by the demands of executive management. Indeed, the PFs recognise that "*events may occur after the reporting date or the date that the financial statements were authorized for issue*"[22]. Although the CC explains that "*[i]n such circumstances, users' perceptions of the accuracy of the financial statements and the perceived quality of the audit may be affected if these events are not reflected in the financial statements*"[23] [emphasis added], this underlines that the fact that simply because some companies collapse after receiving a clean audit opinion this is not, of itself, evidence of audit failure.

2.20 In the circumstances, there is no evidential basis to conclude that auditors compete to satisfy management demand at the expense of shareholder interests.

The outcomes expected from the "well-functioning market" test

2.21 In applying its "well-functioning market" test (that is a market without the features giving rise to the AEC) the CC is, in this case, applying an unrealistically high standard of what outcomes would be expected in such a market. A well-functioning market is not a perfect market and even in a well-functioning market one would expect that there would be occasional errors and failures in audits. The existence of such errors does not of itself indicate that a market is not functioning well.

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18 Paragraph 11.104.
19 We explain our position in more detail in paragraphs 35 and 36 of Annex 1.
20 PFs summary, paragraph 28.
21 Paragraph 11.104.
22 Paragraph 3.24.
23 Paragraph 3.24.

2.22 This is a particular issue in this investigation where the CC has been unable to find poor market outcomes in respect of the more easily measured financial criteria - high prices and high profits. Considerably more weight than would normally be the case in a market inquiry is therefore placed on qualitative measures which, as the CC acknowledges, *"are not amenable to measurement by an objective metric"*[24].

2.23 Thus, in a well-functioning market one would expect profits not to be consistently excessive and therefore, assuming one has a measure of what constitutes an excessive profit, it would be possible to judge outcomes against this measure (although even when assessing profitability the fact that some market players sometimes have higher than normal profits would not be an indication of a poorly functioning market). It is much more difficult to define what quality and innovation outcomes one would expect in such a market and what degree of variance from such expected outcomes would be an indicator of market malfunction.

2.24 This gives rise to three difficulties:

(a) What outcomes would one expect in a well-functioning market? For example, the CC concludes that in a well-functioning market *"customer demand should be satisfied"*[25] and, because there is some demand for further or different information this means that there is unmet demand which indicates an AEC. In all markets that operate efficiently, even in perfectly competitive ones, there is some unmet demand[26]. Unmet demand is an inevitable consequence of the combination of scarcity of resources but limitless demands. The fact that there is some unmet demand is therefore not an indicator of a poorly functioning market. The CC does not explain why, in the circumstances of this market, the level of unmet demand is indicative of an AEC.

(b) The existence of some qualitative failures cannot, on their own, be taken as evidence of a poorly functioning market. Even in a well-functioning market there would be occasions when things go wrong. Effective competition does not eliminate the scope for any mistakes or errors. The CC must therefore indicate more precisely than it does in its PFs what it regards as an unacceptable market outcome. We give examples in the following sub-section of how the CC appears to have applied a standard under which any errors or failures are evidence of malfunction[27] and this is not a justifiable approach.

(c) This is a regulated market that must serve a number of public interest objectives. While we recognise that regulation can of itself be a feature of a market that gives rise to an AEC, this is a different question from whether a particular market outcome, such as limited innovation or unmet demand, is caused by the behaviour of audit firms and/or company management as opposed to the statutory or regulatory regime. To the extent that innovation is more limited than it would be in a well-functioning market the CC must distinguish between, on the one hand, statutory or regulatory rules that give rise to this

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24 Paragraph 7.205(b).

25 Paragraph 7.204.

26 In perfect competition price is equal to marginal costs, so all consumers who attach a value to a product that is equal to or exceeds the cost of supply have their demand met. Those who attach a lower value are rightly left with unmet demand as it would cost more to supply them than the value they would achieve, and to supply them would be inefficient and cause a loss to society.

27 See, for example, paragraph 2.33(a) below.

outcome and, on the other hand, market behaviour related causes. The audit firms submitted extensive evidence and arguments as to how the regulatory regime constrains certain forms of innovation, notably into the form of the published audit report, and change that they would otherwise welcome. The PFs largely reject these arguments[28] but contain no legal analysis as to why the views of the audit firms as to the extent of the constraints have not been accepted. There is simply an assertion that the constraints are less than the firms suggest and a conclusion drawn from this that the cause of limited innovation therefore must be attributable to company management[29].

The CC's approach to the evidence: Serious failures of due process in the evaluation of primary facts

2.25 The CC has acknowledged that *"to a greater extent than in many market investigations, the nature of the evidence base we faced meant that clear-cut distinctions between competing explanations for a number of issues were hard to determine. In these situations, we applied our judgement to reach our provisional findings, having regard to all the evidence available"*[30]. We recognise that when faced with competing evidence and explanations the CC must make a choice, but it does not have an absolute discretion in this regard.

2.26 There are many instances where the CC has exercised its judgement to support its two theories of harm where:

(a) There is no clear evidence available but the CC nonetheless has relied on supposition to reach clear and definitive provisional conclusions: the most striking example is in respect of the CC's provisional findings that auditors are insufficiently independent from executive management and insufficiently sceptical in carrying out audits, as we explain above;

(b) The CC has evaluated the evidence selectively and inconsistently, relying on a source of evidence where it supports the two theories of harm but dismissing alternative explanations of the same evidence that points to the market functioning effectively and ignoring evidence that clearly points in favour of the pro-competitive explanation; and

(c) Broad findings are supported only by a small number of parties, yet other views that suggest the market working effectively have been ignored or discounted.

2.27 This selective approach to the evidence is particularly apparent with regard to the evidence on outcomes, where the CC has reached strong adverse findings in respect of prices, profitability, quality and innovation despite recognising certain challenges with evaluating the evidence and ignoring or dismissing evidence that point clearly towards pro-competitive outcomes. We set out our comments on the seven outcomes identified by the CC in the PFs in Annex 1.

2.28 We also set out below a range of illustrative examples of the concerns described above. We conclude this section by explaining that the CC has also failed to follow an adequate procedure

[28] Paragraph 11.141.
[29] Paragraph 11.142.
[30] Paragraph 2.12.

by not providing the parties with the chance to respond to the CC's position in respect of the principal-agent issues.

Selective and inconsistent evaluation of the evidence to support the theories of harm

2.29 We are concerned that the CC consistently has exercised its judgement and discretion in a manner that selectively supports its two theories of harm. This is illustrated by the CC's approach to the evidence of firms competing to retain audits and on the effectiveness of ACs, as we explain below.

Evidence of firms competing to retain audits

2.30 The CC refers to the substantive body of evidence that shows that audit firms make substantial efforts to retain existing clients. This includes detailed annual reviews of their own performance with audit clients[31]; the use of tools to monitor threats of tendering and facilitate quick actions to mitigate this risk[32]; fee reductions[33] and changes to the audit engagement team[34] in response to pressure from clients.

2.31 The absence of such evidence would have been a strong indication that incumbent auditors felt comfortable in their position and insulated from the effects of rivalry; that they maintained a stronger bargaining position than their clients; and that they were able to withstand pressure from clients to replace underperforming teams and maintain high fees.

2.32 However, the CC does not contemplate that the evidence may be interpreted to support a pro-competitive conclusion. Rather, the CC uses the evidence of efforts by existing audit firms to retain their clients to counter-intuitively support both theories of harm.

2.33 As regards the first theory of harm:

(a) The CC finds that notwithstanding the examples of companies "*on occasion*" exacting competitive pressure on their incumbent firm without moving to a tender process, *"this does not show that <u>all</u> companies can obtain competitive outcomes on <u>all</u> occasions"*[35] [emphasis added]. As we explain above, it would appear that the CC is using the benchmark of a perfectly competitive market where all companies receive competitive outcomes on all occasions. This is an unrealistic and unreasonable benchmark.

(b) The PFs highlight the extent of contact between audit firms and companies and conclude, reasonably, that "*firms can accurately gauge the extent of company discontent and adjust the dimensions of the audit (in terms of personnel and fees) accordingly, and so mitigate the risks of a tender*"[36]. However, rather than conclude that this is a competitive outcome that shows the market working effectively, the CC feels able to reach the provisional finding that *"[a]s a result the firm need not 'give away' any more than is necessary to*

31 Paragraph 9.194.
32 Paragraph 9.195.
33 Paragraph 9.198.
34 Paragraph 9.199.
35 Paragraph 9.217.
36 Paragraph 9.262.

retain a client"[37] because by contrast "*[c]ompanies are less-well placed when it comes to determining at what point (ie how low a fee can be) a firm would be unwilling to act*."[38] The CC does not explain how it has reached this conclusion or what evidence is said to support it. To the extent that the CC's case is that the audit firm is able to achieve a delicate balance between accommodating the client and preventing a threat of tendering from materialising, whilst simultaneously maintaining prices at above a competitive level, it should provide clear evidence to support this theory.

(c) The only attempt by the CC to make this connection with high prices is the broad reference that "*<u>some</u> companies have not obtained competitive outcomes on fees*"[39] [emphasis added]. However:

(i) The evidence shows that prices have fallen in real terms over the last six years, which is wholly consistent with firms responding to company demands for fee reductions[40]; and

(ii) The fact that "some" companies may pay higher fees than others is entirely consistent with what would be expected in a business-to-business market characterised by a series of bilateral fee negotiations where companies' needs and circumstances differ[41]. One would expect to see some variation in fees in a well-functioning market. This appears to be another example of the CC imposing the unrealistic benchmark of the perfectly competitive market.

(d) It follows that this reference to prices is simply not a fair or reasonable basis on which the CC can safely draw the conclusion that *"[i]ncumbent auditors face less competition for their ongoing engagements than they would were the company more willing to switch, thereby ultimately reducing rivalry between firms"*[42].

2.34 The CC also uses the evidence of firms seeking to maintain high standards of performance to support its second theory of harm.

(a) The CC notes "*the efforts that firms expend in maintaining good relationships with company management, including executive management*"[43]; the first survey found that "*most companies regularly carry out reviews of audit performance (internal or with their auditors)*"[44]; and the CC also "*found that firms also carry out detailed annual reviews of their own performance with audit clients, to ensure that the companies are satisfied with*

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37 Paragraph 9.262.
38 Paragraph 9.262.
39 Paragraph 9.217.
40 The Industry Dataset shows that the level of audit fees has declined by 15% in nominal terms (and by more in real terms). The CC's analysis of the engagement data set indicates that the level of audit fees has declined by more than 19% when account is taken of declines in both the average hourly rate and the average number of man-hours per audit (paragraphs 7.30-31). However, the CC seeks to dismiss this evidence for reasons which, as we explain in Annex 1, cannot be justified.
41 For example, in the need for specialists, the complexity of issues involved and the geographic scope of the company's operations.
42 Paragraph 9.262.
43 Paragraph 11.66.
44 Paragraph 11.67.

the service they receive"[45]. Yet rather than finding that audit firms are responsive to the needs of demanding and sophisticated large companies, which have bargaining power, this body of evidence is used by the CC to base a conclusion that firms have "*strong incentives to provide the service that FDs demand, even if such demands do not align with those of shareholders*"[46].

(b) It does not follow from the fact that firms make efforts to understand management views of their services that there is lack of alignment with the interests of shareholders. The binary view that a firm can either be interested in the views of management or those of shareholders but not both is unrealistic. In fact:

(i) The evidence shows that we gather feedback from ACCs as well as from executive management on our audit service[47] and that the factors that ACCs value most highly are the ability to detect misstatements; the independence of the firm; and a high degree of challenge by the auditor[48];

(ii) We have provided the CC with a number of examples of our efforts to engage with the investment community. The quotes contained in the PFs from our surveys of investors demonstrate that we are interested in investors' views just as much as those of management.[49]

(c) Similarly, the fact that audit firms *"put in significant efforts to ensure that AEP rotation is 'seamless', and even offer companies a choice of candidates when an AEP is due to rotate off an engagement"*[50] is not regarded as an indicator of the importance of ensuring that existing audit firms are offering the best available team to ensure high quality and hence to retain the audit, but rather that firms may be compromising their independence. We have explained above that there is no evidential basis on which to safely reach this conclusion. In fact, a failure by existing audit firms to make such efforts to retain the audit would be evidence of a lack of competition.

2.35 This approach towards characterising evidence of audit firms striving to offer high standards of service as indicating that the market is not functioning effectively is also apparent from the CC's view that *"companies and firms invest in a relationship of mutual trust and confidence from*

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45 Paragraph 11.67.

46 Paragraph 11.76.

47 ACCs are actively involved in our ISPR, CPR and CSS client feedback processes - for the financial year 2012, 35 FTSE 350 ACCs were covered in the CPRs, ISPRs and CSSs collectively, together with 17 chairmen.

48 Appendix 3, paragraphs 30 to 31, Tables 9 and 10; see also slides 28 and 60 of the CC's survey.

49 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 (See also MFQ Response (response 113 at 113.6-113.8));
- formal surveys of investor views on audit and corporate reporting as referred to in the PFs: e.g. the Audit Today and Tomorrow survey;
- 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 last year, 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: in the last year, 23 UK partners have met with over 100 analysts in 10 different industries; and
- the "Auditor view" series of publications that offer investors insight into audit in a given industry (http://www.pwc.com/gx/en/corporate-reporting/investor-views)

50 Paragraph 7.146.

which neither will lightly walk away as this means the loss of benefits of continuity stemming from the relationship."[51] By finding this a feature of the market that leads to an AEC, the CC dismisses:

(a) The benefits of continuity:

(i) The CC acknowledges that *"companies valued long-lasting relationships, particularly as incumbent firms acquired significant company-specific expertise over time"* and that losing the auditor might lead to *"(a) reduced efficiency in the conduct of the audit; (b) increased risk in relation to the technical quality of the audit particularly in the early years of the engagement; and (c) a loss of the commercial insight provided by the incumbent firm"*[52].

(ii) However, these benefits are presented as switching costs that deter companies from tendering and switching[53]. This leads the CC to reach the perverse conclusion that the better the service provided by the incumbent auditor, the higher the switching costs faced by the company, thereby providing evidence of a feature of the market said to produce an AEC.

(b) The findings from the CC's survey and the case studies:

(i) The CC makes cursory reference to its survey and case studies in support of its views on the presence of continuity benefits[54]. However, evidence from these appendices confirms that a greater proportion of companies do not intend to switch as they are "*satisfied with the quality of the work that the auditors perform*", with some noting that they are "*very satisfied"* with the audit quality[55]. In fact, the CC's survey shows that the "positive" reasons for not tendering total a cumulative 133% of FTSE 350 responses ("*receive high quality service*", "*receive good value for money*", and "*happy as things are*" are the most common responses), with only 29% offering "negative" responses relating to cost or disruption[56].

(ii) However, the CC has re-interpreted this data as showing that the reason why companies had not tendered their audit engagement in the last five years showed that "*over 60 per cent of FTSE 350 companies responded that this was because they had been satisfied with the performance of their current auditor*"[57]. In fact, only four out of 164 respondents (2.4%) were classified by the CC as saying that they did not carry out a tender because of the time, expense or uncertainty involved (i.e. a "negative" reason), with the balance being categorised as either "mixed" or "other". It follows that the CC has downplayed that the overwhelming reasons for companies choosing not to tender are because they are content with the quality they obtain from, and price they pay to, their existing auditor.

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51 Paragraph 9.260(a)(iii).
52 Paragraph 9.159.
53 Paragraph 9.163.
54 Paragraph 9.160.
55 Appendix 3, Annex 2, Table 2.
56 CC's survey, Slide 60.
57 Paragraph 9.152.

(iii) Moreover, the PFs recognise the survey's findings that the "*potential trigger most frequently identified as very likely or likely to prompt a company seriously to consider switching is the complacency of the audit firm (86 per cent of FTSE 350 FDs and 94 per cent of FTSE 350 ACCs)*"[58]. This evidence is overlooked in the context of CC's analysis of the role of the benefits of continuity in this market.

Evidence on the effectiveness of ACs

2.36 The PFs consider whether the introduction of ACs and the regulatory developments since 1992 (and the Cadbury report) have remedied any detriment arising from any misalignment of auditor incentives with those of shareholders. The CC states that: *"[a]t this stage of our investigation, we do not think that they have"*. The CC feels able to reach this conclusion despite acknowledging that it *"encountered difficulties in evaluating the evidence on AC effectiveness"*[59]. The CC has grossly underestimated the role of the AC by exercising its discretion to discount the following evidence:

(a) The ACC survey was recognised by the PFs as showing that *"more than 90 per cent of the [ACCs] were either 'very confident' or 'quite confident'"*[60] in assessing the credentials of an audit team and that *"on occasion the ACCs act independently of executive management in their review of the external financial reporting and auditing."*[61] This body of evidence was dismissed on the basis that *"it might be unreasonable to expect ACCs to comment critically on the effectiveness of ACs in carrying out their responsibilities"*[62]. However, the PFs should have placed greater weight on the fact that:

(i) Over three-quarters of ACCs report no constraints at all on their ability to carry out their role.[63]

(ii) For the 12 areas covered in Appendix 4 Table 11 of the PFs, which notably includes "*the satisfactory resolution of issues identified by the auditor*", AC/ACC engagement is 93%. Leaving aside "audit sampling" which most would consider outside the AC/ACC scope of enquiry in normal circumstances, the engagement is even higher, at 98%.

(iii) Over half of ACCs requested supplementary information on external audit matters beyond those expected to be provided as part of the normal AC agenda.[64] 72% of those who did not request such supplementary information felt this was because additional information was not needed and 28% felt that this was dealt with during prior discussions.[65]

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58 Paragraph 9.182; Appendix 3, Table 20.
59 Paragraph 11.52.
60 Paragraph 9.89.
61 Paragraph 11.37.
62 Paragraph 11.52.
63 Appendix 4, Table 6.
64 Appendix 4, Paragraph 20 and Table 7.
65 Appendix 4, Table 9.

(b) The CC's survey and case study interviews with ACCs led the CC to form the impression that "*they are well qualified, knowledgeable and diligent individuals who take the role seriously and have a reputation to protect*"[66]; and the PFs correctly conclude that *"ACCs and other AC members are typically senior individuals with an established professional reputation who should act with integrity … ACs have incentives to ensure that auditors carry out a thorough investigation"*[67]. These views should have led the CC to conclude that ACs are usually effective (notwithstanding that there may be scope for further improvement);

(c) The findings in our 2011 and 2012 surveys of investment professionals which showed that very few investors had direct contact with AC members and did not regularly read AC reports. Therefore, views of investors regarding lack of independence of ACs may be perception rather than reality.

2.37 Instead, the CC places considerable weight on the views of Beattie (2012) to reach the conclusion that *"there are limitations in the ability of the AC under the stewardship of the ACC, at least in its current incarnation, to ensure audit quality and independence of the auditor"*[68]. The weight placed on this work is inappropriate because:

(a) The underlying data for this research dates from 2007 and nearly one-third of its data relates to companies outside the FTSE 350. Since 2007, AC practice has continued to evolve with guidance in September 2010 and September 2012; the Financial Reporting Council's (FRC) paper "Effective Company Stewardship"; and the revised auditing standard ISA (UK&I) 260. It follows that a more reliable and current measure of AC/ACC engagement within the FTSE 350 audit market is the current data derived from the CC's follow-up ACC survey (which, as summarised above, shows that the AC is broadly effective).

(b) It is inconsistent in a number of respects with Beattie's 2011 research (which is a book of over 200 pages rather than the 25 page study produced in 2012). For example, Beattie (2011) included the following conclusions[69]:

(i) "*Engagement of ACC and audit committee. The study provides evidence that ACCs are fully engaged with the financial reporting [and audit process[70]]*…

(ii) "*Interaction process. …both the CFO and AEP are accountable to the ACC, who manages the AC. Consequently, interactions now tend to be characterized by problem-solving behaviour and rarely by disagreement and confrontation*.

(iii) *"Power. Corporate governance changes, combined with the strength of the enforcement bodies, have changed the power relations between the key parties.*

66 Paragraph 11.54.
67 Paragraph 11.54.
68 Paragraph 11.55.
69 The key findings of Beattie's 2011 research are outlined in V. Beattie, S. Fearnley, T. Hines *Reaching Key Financial Reporting Decisions: How UK Directors and Auditors Interact* (2011) at section 1.6, and the conclusions are set out in more detail in section 17.
70 See Beattie (2011), section 17.8.

The ACC (and audit committee) have gained power on accounting and auditing matters at the expense of the CFO and AEP."

(iv) "*Ease of outcomes. … The enhanced role of the audit committee made it more difficult for other executive directors to get heavily involved in decisions*." [emphasis added]

2.38 In conclusion, we do not believe that the existence of a few observed limitations on the role of the AC is sufficient for the CC to justify the conclusion that ACs are not effective in managing the misalignment between the executive management and shareholders. Notwithstanding this position, we do believe that there is scope to enhance and clarify the role of the AC and we deal with this in our response to the remedies (and remedy 5 in particular) in section 3.

Reliance on selected views to justify a broad conclusion

2.39 The CC has also supported broad findings with evidence from a small number of parties, who may be unrepresentative. For example:

(a) In reaching the provisional view that there is an AEC that auditors are failing to respond to the demands of shareholders, the CC assumes that there is a clear demand which is economically justifiable to meet but which is not being satisfied in the current market. However, the evidence shows clearly that shareholder demand was "differentiated".[71] It therefore appears that the CC is placing weight on the views of only some investors:

(i) Our survey "Audit today and tomorrow" illustrates the danger of such an approach, highlighting a number of areas where the views of the governance community are substantially different from those of mainstream investors and analysts. For example, mainstream analysts are more positive about auditor independence than corporate governance specialists, where 46.5% of mainstream analysts either agreed or strongly agreed with the statement that auditors are sufficiently independent of management; 20% did not have a strong view either way and only 33.5% disagreed or strongly disagreed with the statement. By contrast, only 14% of the governance specialists agreed or strongly agreed with the statement and 57% disagreed or strongly disagreed.

(ii) The CC also fails to take into account the evolving practices of the market whereby greater transparency is being achieved. The FRC's and International Auditing and Assurance Standards Board's (IAASB) recent enhancements to AC and auditor reporting is further evidence of the industry taking steps to first identify and then meet the needs of the investor community.

(b) The CC finds that from the point of view of some companies there is little perceived differentiation between the Big 4.[72] These were a minority of views from the CC's surveys and case studies. Notwithstanding this, the conclusion on limited differentiation

[71] Paragraph 11.123.
[72] Paragraph 9.186.

is then used to support a further conclusion on adverse market outcomes, which is that in a market with greater choice of suppliers one would expect to see greater differentiation[73].

(c) By contrast, in the case studies, companies generally expressed a positive view of auditor quality[74]. However, this evidence is totally disregarded in coming to a view about audit quality[75].

Procedural unfairness

2.40 Finally, we object strongly to the procedure that the CC has followed by failing to give the parties the opportunity properly to comment on the central tenet of the second theory of harm (and indeed the entire PFs): that auditors are satisfying the demands of management, which may differ from those of shareholders.

2.41 At no stage of its investigation did the CC present any substantive evidence to support its case that auditors to FTSE 350 companies lacked sufficient scepticism and independence to support the second theory of harm. Indeed, when the CC stated that it did not intend to issue a working paper on "principal-agent issues" (which it had earlier indicated it intended to do, as it did for most other substantive aspect of its PFs), the CC explained that this was because "*we consider we have received sufficient evidence and comments from interested parties for the Group to be able to take these into account, make its assessment and reach a provisional finding, without the need for further comments from parties.*"[76] However, in circumstances where the CC intended to rely on specific examples of alleged lack of independence and scepticism, and generally infer that audit firms were acting in breach of their legal and regulatory duties to companies (in the interests of shareholders), we (and the other main parties) had a legitimate expectation that the CC would issue a working paper setting out its position. This would have given the parties an opportunity to present their position and correct any factual inaccuracies and misconceptions.

Conclusion

2.42 The fundamental concerns set out above, which we supplement in Annex 1 (where we explain the CC's selective approach to the evidence on outcomes) and Annex 2 (where we comment on the features identified by the CC in respect of the two theories of harm), demonstrate that the CC should re-consider its approach to the evidence and the conclusions that can properly be reached when making its final decision.

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73 Paragraph 7.28.
74 Paragraph 7.99.
75 Paragraph 7.119 to 7.121.
76 Email from Dipen Gadhia of the CC to Peter Scott of Norton Rose LLP dated 10 December 2012

3 Possible remedies

3.1 Notwithstanding our fundamental concerns regarding the CC's approach and the flaws in the PFs set out in section 2, we support measures that ensure the audit continues to evolve to remain relevant and valued by the capital markets. As we explain in our covering letter of 22 March 2013, we support remedies that are designed to:

(a) Promote competition and choice;

(b) Enhance audit quality and innovation; and

(c) Increase the level of transparency between auditors, ACs and shareholders,

and are proportionate.

3.2 The combination of measures that would best meet these criteria would be the new FRC tendering regime; enhanced by a more prominent role for the AC (remedy 5); greater shareholder-auditor engagement (remedy 6); more auditor and AC reporting (remedy 7); a refined role for the Audit Quality Review Team (AQRT) (remedy 3) and the removal of any "Big 4 only" clauses in loan agreements (remedy 4). This package of remedies would improve the functioning of the market and address the AECs that the CC identifies in the PFs[77] while avoiding detrimental and disproportionate adverse effects.

3.3 It is essential to view such a package of remedies holistically rather than assessing each individual component in isolation. For example:

(a) empowering shareholders to take a more active interest in the audit (remedy 6), coupled with the enhanced role of the AC (remedy 5), where the ACC can be expected to take a more visible shareholder-facing role (remedy 6), underpins the new provision in the FRC's UK Corporate Governance Code (the Code) whereby ACs are incentivised to put audits out to tender on a regular basis;

(b) shareholder empowerment (remedy 6) will inform the AC as they make auditor appointment decisions (remedy 5) and encourage greater transparency around the process (remedies 6 and 7); and

(c) when reviewing their existing auditor and evaluating alternative firms, the AC (remedy 5) will have access to additional information about audit quality from the AQRT (remedy 3) as well from audit firms.

3.4 It is important to ensure that the remedies address the CC's concerns in a balanced manner. They should not impose a disproportionate burden on companies or firms or give rise to adverse consequences for competition, quality or accountability. We do not accept the need for mandatory rotation, which will reduce choice, increase costs and undermine quality. Neither, in light of the recent changes to the Code introduced by the FRC which will materially increase the

[77] Our comments on proposed remedies are without prejudice to our views concerning the CC's PFs as set out in this Response. These comments therefore assume without accepting that there is an AEC as described in the PFs.

number of tenders, do we believe that there is any basis for requiring companies to tender more frequently than at least every 10 years or requiring companies to tender on an "open book" basis.

The appropriate package of remedies to address the CC's concerns

3.5 We outline in the following paragraphs our views on the appropriate remedies to address the CC's concerns on the two theories of harm (principal-agent issues and barriers to switching). We then set out our position in respect of the seven possible remedies identified in the RN.

Principal-agent issues and how to address these

3.6 The audit market serves important public interest objectives and we recognise and take seriously the "expectation gap" between the audit as currently provided and what a number of stakeholders believe it should provide. As the CC acknowledges, it is this expectation gap that *"may lead to a perception of audit failure if users of the financial statements expect that the auditor should have either detected or foreseen [events that may have occurred after the reporting date or the date that the financial statements are authorised for issue]"*[78] and that led to questions being asked of the role of the audit in the 2008 banking crisis.

3.7 As the CC has recognised,[79] we (and other firms) have been engaging with for some time with the issue of "unmet demand" from the current audit process and have made at least some progress in this respect[80]. The FRC and AASB also are consulting on how audit reporting should evolve to address unmet demand[81]. This is important because a number of the changes will require action by or support from the regulator. While it is the case that different investors want different things from the audit process, we recognise that there is more we and others can do to ensure that the demands of shareholders are met by an audit that meets their collective needs.

3.8 The AC is explicitly designed to safeguard the interests of shareholders in financial reporting and internal control and an important element of this is the oversight of the external audit process. In our experience, in the vast majority of companies, ACs perform their duties well and we believe that the CC's findings to the contrary grossly underestimate their role. However, we agree with the CC that there are a number of ways in which the AC's role could and should be strengthened to make it clearer and more effective. In particular, we believe that the Guidance to ACs should clarify that ACs have clear responsibilities for auditor appointment and that the AC should be involved in overseeing the auditor in sufficient detail to understand and appreciate material issues.

3.9 We believe that further strengthening the role of the AC - albeit with care to avoid unintended detrimental consequences[82] - is critical to ensure and demonstrate that in future the competitive

78 Paragraph 3.24.
79 Paragraph 7.200.
80 PwC's response to Certain Third Parties' Submissions, paragraphs 2.17 to 2.19; PwC's Response to Views of Investors and Other Stakeholders Working Paper (WP) (4 December 2012), paragraph 6(c).
81 See, for instance, paragraph 11.132.
82 As we explain in section 2, it will be important to ensure that companies remain able to attract high calibre AC members and that the integrity of the unitary board is preserved.

efforts of the audit firms (that the CC has observed takes place) is on parameters where independence and scepticism of management are seen as being fundamental to the performance of the statutory audit.

3.10 Strengthening the role of the AC in this way, coupled with proportionate and sensible measures to refine the role of the AQRT, enhance shareholder and auditor engagement, and extend reporting of audit matters in the AC's and auditor's reports, in our view would be effective in addressing the adverse effects that flow from any current misalignment between shareholders and management. As such, the need for highly intrusive measures - in particular, mandatory firm rotation and requiring companies to tender every five or seven years - which would have significant consequences for choice, quality and cost falls away.

Addressing barriers to switching and increasing rivalry on the right parameters

3.11 We note that in the press release the CC states that it is looking to *"create a situation where tendering and switching become the norm"*[83]. It is not appropriate for remedies to aim for switching to "become the norm" and it is not necessary for this to be the case to address the AECs identified in the PFs. Remedies should be designed to ensure that companies (led by the AC) can assess whether their existing auditor is providing an independent and high quality audit that offers good value for money. If the existing auditor is the most suitable, the companies should not be forced to switch.

3.12 As regards tendering becoming the norm, the CC does not give weight to the fact that following the recent changes to the Code, companies are now required to tender the audit appointment at least every ten years (or to provide a good explanation each year as to why they have not done so). The vast majority of large companies comply with all material provisions of the Code[84]. Therefore, the CC should recognise that although the market it has investigated was not characterised by frequent tendering, this will change and tendering will become a regular feature of the market under the new FRC regime.

3.13 Although the new regime has only just been introduced, it already is having an impact on tendering and switching activity. Tender activity in the FTSE 350 audit market will increase from an average of roughly eight to ten a year,[85] to an average of 35 a year. In our experience, the implications of the new tendering regime (and the sensible transitional arrangements that the FRC has suggested) are on the agenda of most ACs (and are already expressly referred to in over 20 FTSE 350 companies' annual reports for 2012). Indeed, there already have been some significant developments in the market since the changes were announced, with HSBC announcing a tender and BG, RSA and Cairn Energy deciding to switch auditor following a tender. They cannot be disregarded by the CC as too early, or too small as a percentage of the FTSE 350 population. They certainly are regarded by PwC and, we would assume, our rivals

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83 See footnote 2.

84 See the FRC's response to the CC's PFs and RN: "Provisional findings and possible remedies" (18 March 2012) (FRC's response to the PFs), page 2: "*[o]ur most recent survey illustrated a 90% compliance rate with the requirements of the Code*"; Grant Thornton's "Corporate Governance Review 2012": which confirms that FTSE 350 companies comply with 97% of the Code's provisions and the level of compliance across the FTSE 350 has increased year on year since 2005.

85 Paragraph 9.240 and Appendix 24, Paragraph 5(a).

as evidencing a sea change in the relationship between the company and any auditor of long standing.

3.14 This new regime of regular tendering - when coupled with the enhanced role of the AC and the removal of artificial barriers - is sufficient in our view to address the AEC that flows from features (a) to (c) of the PFs (being barriers to switching; opportunity costs deterring management; and barriers to expansion and selection faced by mid-tier firms). We do not believe that mandating that companies tender every five or seven years, or forcing companies to rotate audit firm every seven, ten or 14 years, is justifiable or proportionate.

3.15 We provide our comments on the seven remedies proposed in the RN below (always bearing in mind that the impact of these remedies must be considered in the round as a package), and in Annex 3 we answer the detailed questions set out in the RN.

Remedy 1: Mandatory tendering

3.16 The FRC's changes to the Code to require companies to tender the audit every ten years (or to explain each year subsequently why they have not done so) is leading to a sea change in the approach of companies to tendering their audits. As we have explained above (paragraph 3.13), these changes already are having a substantial impact on the behaviour of companies, with the topic high on the agenda of most ACs, who are also carefully evaluating the Code's transitional provisions that are designed to minimise disruption. These changes are not a temporary response to the current focus on audit tendering. The amendments to the Code will be permanent.

3.17 We believe that this new tendering regime, which was implemented after extensive consultation by the FRC with all of the relevant stakeholders, should be given an opportunity to work before being dismissed as inadequate by the CC.

3.18 Notwithstanding this, we believe that the new FRC regime could be strengthened further by:

(a) making clear that ownership of the audit appointment and tendering process is firmly placed within the remit of the AC (as we explain in respect of remedy 5 below); and

(b) ensuring that the tender process facilitates more effective exchanges of information between companies and bidding audit firms so that there is no doubt that there is sufficient knowledge on both sides to ensure a level playing field for the firms and to facilitate thorough analysis by companies of the competing offers.

3.19 There are three aspects of the proposals in the RN on mandatory tendering that we disagree with:

(a) We do not accept that the proposal to materially increase the frequency of tenders to every five or seven years is likely to be effective in achieving the aims listed in paragraph 23 of the RN: being (a) to encourage more frequent tendering and increase the possibility of switching, increasing companies' bargaining power and the incentives for auditors to compete; (b) to provide greater opportunities to mid-tier firms to tender; and (c) to reduce

the incentives of auditors to compete to satisfy management rather than shareholder demand (together, the aims of this remedy). There are less onerous ways of achieving these aims and the proposal would produce very substantial disadvantages that are disproportionate to the aims.

(b) We consider that the proposal to cease the FRC's "comply or explain" regime and force companies to tender at certain times, regardless of the circumstances that they might find themselves in at that point, is not necessary or proportionate to achieve the aim of ensuring that all large companies tender the audit at regular periods.

(c) While we welcome remedies designed to make the tender process more effective and efficient, thereby reducing the costs otherwise incurred by both companies and audit firms in participating in a tender, the proposal to require tenders to be run on an "open book" basis requires the existing audit firm to share its working papers with other bidders. This will produce very material disadvantages which are disproportionate to the aim of improving the efficiency of the tender process.

3.20 We explain our position in respect of these three components of the proposed remedy below.

The proposal to double the amount of tendering (i.e. every five/seven years)

3.21 We explain below why requiring companies to tender every five/seven years would:

(a) reduce the effectiveness of the tender process, thereby defeating one of the CC's stated aims of increasing companies' bargaining power;

(b) be more onerous than is necessary;

(c) be inappropriate because other remedies could achieve the same objectives in a less onerous way; and

(d) lead to disadvantages that would be disproportionate to its aims.

Reduction in the effectiveness of the tender process

3.22 The CC has found that under the current tendering arrangements (i.e. pre the FRC regime): "*audit firms have the incentive to compete intensely during tender processes*".[86] The PFs explain in detail the features of the current tendering regime that result in tenders being highly effective when they take place. These are:

(a) The fact that tenders are relatively infrequent: As the CC has found, the "*low frequency of opportunities to acquire new engagements [means that] firms have a strong incentive to compete intensely for engagements when the opportunities arise*"[87];

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86 Paragraph 9.255(a).
87 Paragraph 9.241.

(b) Companies take the process seriously: The CC recognises that "*there is a (possibly significant) opportunity cost in senior management time of launching and running a tender … Accordingly, having taken the decision to tender the audit, we expect that management and the AC take the process seriously. For example, we know that the process allows firms to have access to individuals and information they need to prepare tenders. This includes contact with the FD and ACC*."[88]

(c) Invited firms stand a good chance of success: The CC finds that because companies recognise the importance of only inviting firms with a realistic prospect of success, this means that *"all else equal, the probability that a given firm will be successful in winning the engagement is higher once it has been invited to participate"*[89]. This means that *"[i]f invited to tender, Big 4 firms will generally participate" and that "[t]ender lists typically include at least three Big 4 firms"*[90].

3.23 These dynamics would change significantly if tenders were to take place every five/seven years. Being invited to tender would no longer always signal to the bidders that the company was seriously considering switching auditors. Rather, it may be that sometimes the company would be regarded as "going through the motions" of complying with its obligations to conduct a formal benchmarking exercise with no intention of switching (particularly if the company appointed a new audit firm five years ago and has therefore incurred the costs of educating that auditor on the business in the relatively recent past). This in turn would blunt the incentives of the audit firms to compete intensely to win appointment, and would risk devaluing the currency of the tender process. This would lead to the proposed tendering regime failing to achieve its first aim of increasing companies bargaining power and the incentives for auditors to compete.

3.24 We have also explained in detail in paragraph 20 of Annex 1 that the CC's suggestion that if companies tendered and switched every three years they might expect to achieve price reduction of 7% per annum is wrong and not supported by the evidence.

More onerous than is necessary

3.25 Doubling the frequency with which tenders take place would be more onerous than necessary to achieve the CC's objectives. The FRC's new regime will lead to an average of 35 tenders taking place every year across the FTSE 350. The CC's proposal to require companies to tender every five years would lead to an average of 70 tenders a year. This would be more than an eight-fold increase on current levels, and twice the level adopted by the FRC.

3.26 The CC has not explained why such a substantial increase in tenders is necessary to achieve the objective of the aims. For example, mid-tier firms can expect to be provided with many more opportunities to tender for FTSE 350 audits under the new FRC changes than is currently the case.

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88 Paragraph 9.255(f).
89 Paragraph 9.242.
90 Paragraph 9.255(b).

Other remedies could achieve the same objectives in a less onerous way

3.27 Further, the CC has not taken into account how other less onerous measures which it is considering would, in combination with the new FRC tendering regime, achieve the aims of the remedy. These include:

(a) Enhancing the role of the AC: Notwithstanding the CC's conclusion that ACs are not currently resolving the misalignment of auditor incentives with those of shareholders[91], the CC nevertheless has accepted that *"the AC is an important and, by and large, powerful force in directing audit firms towards satisfying the demands of shareholders"*[92]. The proposals set out in remedy 5 are aimed at enhancing the effectiveness of the AC in this respect. This is a less onerous way of achieving the third aim of reducing the incentives of auditors to compete to satisfy management rather than shareholder demand (which, for the reasons set out in paragraphs 2.13 to 2.20 above, we do not accept as justified in any event).

(b) Improving the ability of companies to compare the incumbent audit firm's price and quality without tendering: The PFs conclude that currently *"the majority of FTSE 350 companies regularly and actively make comparison of the incumbent auditor's offer with that of rival firms".*[93] Notwithstanding the fact that the CC finds that companies may face uncertainties in appraising auditors outside of a tender process, the CC has not explained why it is necessary to double the frequency of tenders when it could less onerously improve the information available to companies to use when carrying out their regular benchmarking exercises. For example, we explain in respect of remedy 3 below and in Annex 3:

(i) We believe that refining the role of the AQRT should allow its reports on quality to be of greater value to companies in assessing the quality of its existing auditor and that of rivals.

(ii) 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 AQRT'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.

Disadvantages disproportionate to the aims of the remedy

3.28 The increased volume of tenders across the FTSE 350, which would result from increasing the frequencies of tenders to five or seven years, is disproportionate to the aims, given the very

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91 Paragraph 11.102.
92 Paragraph 11.98.
93 Paragraph 9.141.

substantial increase in costs that will be involved for both companies and audit firms (notwithstanding efforts to streamline the tender process, which we comment on in paragraphs 3.47 to 3.48 below). Substantial costs would be incurred by both companies and audit firm, as follows:

(a) Management costs: The CC concludes that *"while we do not have quantitative data, it appears that running a tender process can be onerous for some companies: the cost, principally in management time, appears related to the size, complexity and geographic spread of the company. We note that very senior management time is required"*.[94]

(b) Firm costs: The CC finds that *"the average staff costs of tendering as a proportion of the proposed fee for the first year of the audit by firm range from 20 to 60 per cent and that for some engagements the ratio of costs to fees was considerably higher than average"*.[95]

3.29 The CC does not attempt to explain why it would be proportionate to double the number of tenders from that which the market can expect to see over the course of the next few years, as the effects of the new FRC regime are felt,[96] by reference to the very substantial increase in costs that both companies and firms will be required to incur as a result.

3.30 In conclusion, on the basis that ACs will be responsible to shareholders for ensuring that the auditor is performing well and remains sufficiently independent (which can be addressed as part of remedy 5), the CC has not provided any evidence to justify removing the discretion of the company as to when to tender the audit - subject to every large company's obligations under the Code to tender at least every ten years.

Mandating that tenders take place rather than remain on a "comply or explain" basis

3.31 Mandating that tenders must take place in any given year is not necessary to increase the amount of tendering and is not in the best interest of companies. The CC has not explained why it believes that companies will systematically explain rather than comply with the requirement to tender the audit, in circumstances where the evidence shows clearly that companies take their obligations under the Code very seriously and comply with the vast majority of other requirements that operate on the same "comply or explain" basis.

3.32 The evidence shows that maintaining the "comply or explain" basis for tendering the audit will be effective in achieving the aim of increasing the amount of tenders taking place. The rationale behind the Code is that companies are expected to comply with a broad range of good practices, or provide an explanation to shareholders as to why they have chosen to do otherwise. The evidence shows that companies are highly compliant:

(a) In the FRC's recent response to the PFs, it notes that the "comply and explain" approach is already showing signs of "*working well and generating pressure to consider switching*"

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94 Paragraph 9.253.

95 Paragraph 9.249.

96 Indeed, the FRC felt the need to introduce transitional arrangements in order to avoid all FTSE 350 companies affected (i.e. those who had not held a tender during the previous ten years) from complying immediately, all at the same time, on the basis of the potential for significant market disruption.

and its most recent survey illustrated a 90% compliance rate with the provisions of the Code.[97]

(b) Similarly, in Grant Thornton's 2012 annual survey of compliance across FTSE 350 companies:[98]

(i) Grant Thornton concluded that, overall, FTSE 350 companies comply with 97% of the Code's provisions;[99]

(ii) the level of compliance amongst the FTSE 100 was around 10% higher than for the FTSE 250 companies; and

(iii) the level of compliance across the FTSE 350 has increased year on year since 2005.

3.33 Further, requiring tenders to occur at designated times would be disproportionate to the aim because:

(a) Without the flexibility of explaining why a tender is not appropriate in any given year, companies may be forced to incur the costs and distraction of a tender at a time when it is in shareholders' better interests for the company to be focused on other important events[100]. For example, where a company is facing a financial or reputational crisis, or has just acquired a major new business, or where the ACC or FD has just left the company, it may well be in the best interests of the shareholders for that company to explain that it has not tendered the audit appointment that year. However, in these circumstances, it would be expected to tender in the following year.

(b) Further, the CC has found that at those times when a company is otherwise engaged with another priority that might prevent it from switching auditor, *"we do not think that at these times the company will be in a strong bargaining position with respect to price or service quality".*[101] We have explained in paragraph 2.18(a) that we do not take advantage of companies in such situations because this would be counter-productive in the longer term and damage our reputation. However, the consequence of this remedy is that some companies would be forced to tender at times when the CC considers they would lack bargaining power.

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97 See the FRC's response to the PFs, page 2.

98 Grant Thornton "*Corporate Governance Review 2012*".

99 51% fully complied, with a further 10% complying for part of the period. Amongst those choosing to explain, usually they were found to comply with all but one or two provisions, in respect of which 73% give more than a basic explanation and 44% indicate that they intend to comply in the next period.

100 See also the FRC's response to the PFs, at page 2, where it notes that "*removing the flexibility of 'comply or explain', could lead to retendering in an inappropriate year, contrary to investors' interests, for example when the challenges facing a business, such as a major restructuring or takeover defence, make audit continuity important. Such an outcome is inconsistent with the Commission's objective of ensuring auditors better serve the needs of shareholders.*"

101 Paragraph 9.171.

Open book tendering

3.34 We welcome measures to increase the effectiveness and efficiency of the tender process. Under the new FRC regime, with the number of tenders in a year expected to increase by more than three times, we believe that it will be important for both companies and firms to make the tender process efficient. We would support guidance from the FRC to companies on how to conduct an efficient tender process, including the relevant information that as a matter of best practice should be made available to all bidders.

3.35 However, to the extent that "open book" tendering obliges the existing auditor to make available its working files, or the company to share the full audit plan and other highly sensitive documents, this is not necessary to improve the tender process and could have serious unintended consequences.

(a) Any guidance should allow the company to identify and make available useful material on which audit firms can base their pitches, but also ensure that highly confidential and sensitive material is not disclosed to bidding firms who may be, or become, the auditor of a competing company.

(b) Access to the existing auditor's working file on a tender should not be permitted, because this could:

(i) Breach client confidentiality: Audit working papers are likely to contain significant price and/or reputation sensitive information about the company which would not be appropriate to share with a number of bidding audit firms, only one of whom will ultimately be successful;

(ii) Stifle innovation: This is because innovative methods would be frequently shared effectively with competitors thereby diminishing the incentives that audit firms have to obtain competitive advantage. This effect would run counter to the CC's stated desire to increase innovation;

(iii) Compromise the benefit of a "fresh approach": To the extent that access to the existing auditor's accounting judgements potentially would form the basis of that bidder's approach to auditing the company, this might make the remedy ineffective in achieving one of the benefits of switching - being a "fresh approach"; and

(iv) Increase bidding costs: Bidders might be obliged to review the existing auditor's files in order to make the most detailed proposal possible. This could make the measure counter-productive from another of its stated aim.

3.36 Finally, "open book" tenders are not appropriate or required to *"reduce the risks of switching following a tender".*[102] Audit handovers already are separately defined and regulated by Institute of Chartered Accountants in England and Wales (ICAEW) regulations enacted through the Companies Act, which requires the outgoing auditor to share extensive information with the

[102] RN, paragraph 22.

incoming auditor, including audit plans, reports to the ACs, any critical matters, methodology and use of specialists. Therefore, "open book" tendering does not reduce the risks of switching, as this is already covered by handover requirements, but it does have the potential to jeopardise the effectiveness of tenders owing to the risks outlined above.

Remedy 2: Mandatory rotation

3.37 We do not support mandatory firm rotation (MFR). It would not be an effective remedy; it is materially more onerous than needed; there are less onerous options available; and it would produce disadvantages significantly disproportionate to its aim. This remedy also imposes the loss of relevant customer benefits.

3.38 The aims of this proposed remedy are to (a) realign the incentives of auditors to compete to satisfy shareholder demand (i.e. to ensure greater independence of the audit firm from management); (b) reduce barriers to non-Big 4 audit firm selection by providing greater opportunities for non-Big 4 audit firms to tender; and (c) removing (or overriding) current barriers to more frequent tendering by companies (collectively, the aims of this remedy).[103]

MFR is not an effective remedy

3.39 The aims summarised in sub-paragraphs (b) and (c) immediately above are to increase the extent of tendering (not switching) and can be achieved effectively by the new FRC tendering regime, enhanced as we suggest in response to remedy 1 above. Tendering is obviously a less onerous option for companies (who would not be forced to incur the costs associated with changing audit firms where they did not consider such costs to give rise to equivalent levels of benefit). As such, rotation is clearly disproportionate to these two aims.

3.40 This leaves the only possible justification for requiring a large company to switch to a different audit firm after a set period being to maintain the independence of the auditor (i.e. the first aim of the remedy). The CC has not provided any clear or cogent evidence that the current system of requiring AEP rotation every five years is insufficient to address this aim. The example referred to by the CC of a Big 4 firm aiming to achieve a "*seamless transition*" between AEPs,[104] is not evidence of a lack of independence or insufficient professional scepticism but rather demonstrates the audit firm's attempt to provide an efficient service. The evidence from the FRC is reported as being that "*the effectiveness of the rotation was very much dependent on the individual auditor*".[105]

Other remedies could achieve the same objectives in a less onerous way than MFR

3.41 There are other remedies that in combination are a substantially less onerous (and also more effective) way of realigning such incentives and addressing any lack of independence and scepticism. This is principally achieved by enhancing the role of the AC (as we explain in remedy 5 below), in combination with any refinement to the role of the AQRT; enhancing auditor-shareholder engagement; and extending reporting requirements in the AC's and

[103] RN, paragraph 31.
[104] Paragraph 7.127.
[105] Paragraph 7.129.

auditor's report. These remedies are equally or more effective than mandatory rotation in addressing the AEC and are substantially less onerous and intrusive.

MFR has disadvantages disproportionate to the aims of the remedy

3.42 Mandatory rotation produces significant disadvantages that are disproportionate to its aim:

(a) It would reduce choice in a market that the CC considers to be highly concentrated:

(i) By definition, mandatory rotation would always reduce the choice of audit firm available to companies by one. As highlighted by the FRC, *"[c]ompanies need to be able to secure the best auditor for their business and should not have their choice of auditor artificially constrained. This is particularly necessary when not all audit firms have expertise in a company's business area - such as insurance and banking*".[106] The CC acknowledges that there is currently a credible choice available to large companies on tender.[107] However, no analysis has been conducted as to whether, if choice was reduced by one, there would continue to be sufficient choice.

(ii) In those sectors where there are recognised leading firms, companies would be forced to instruct lesser specialised firms, which could lead to a reduction in audit quality (i.e. they would be forced to appoint their second choice auditor).

(iii) There are a number of sectors where the CC has found that the choice of audit firm is particularly limited,[108] including those where mid-tier firms are not capable on their own admission of conducting the audit.

(b) The RN recognises the likely consequences of a reduction in choice by stating that in some cases it will be necessary for the FRC to "*grant relief from the requirement to switch auditor*".[109] In the absence of such an exemption requirement some companies could likely end up without a suitable auditor. The CC's proposal would make the FRC the ultimate decision-maker in respect of audit appointments to a number of the UK's largest companies - a role that it has not been established to perform and that it has expressed a reluctance to take on[110]. To be clear, this function will need to involve more than simply giving a formal waiver from a mandatory rotation obligation:

(i) The FRC would need to investigate whether the alleged circumstances giving rise to the waiver request can be justified. For example, if a company considers that its existing audit firm (firm X) is the one best able to perform its audit and another audit firm (firm Y) considers that it is capable of doing the job, the FRC is placed in

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106 See the FRC's response to the PFs, page 3.
107 Paragraph 9.56.
108 Paragraph 9.27.
109 Paragraph 33 of RN.
110 See FRC's response to the PFs, page 3: "*[w]e are reluctant to take on such a role because we believe it would fracture the line of accountability from the board to shareholders with whom the ultimate decision whether to accept the 'explanation' should rest*."

the invidious position of having to judge the reasonableness of the company's judgement.

(ii) This would require the FRC to investigate the scope of the audit as defined by the company and the qualities it requires of its auditor. The FRC will also have to judge the respective merits of firms X and Y against the company's requirements with the consequent risk to the reputation of firm Y if the FRC decided that it is not capable of conducting the audit.

(iii) Such deliberation could extend into other areas. For example, if the company feels unable to appoint firm Y because firm Y is the best to perform consultancy services that would not be compatible with firm Y's independence as an auditor, would the FRC be required to consider whether there are appropriate alternatives to firm Y for the consultancy services?

(iv) This would be an extension to the FRC's current role and would give rise to conflict concerns (because the FRC will be monitoring the quality of audits performed by the firms that it has *de facto* selected).

(c) It would force companies to incur substantial switching costs: Rotation forces companies to incur considerable costs associated with appointing a new audit firm:

(i) The CC has found that there are material costs involved in educating a new auditor (including the management team's opportunity costs).

(ii) There is also a recognised potential reduction of audit quality in the early years of a new audit appointment as the audit firm gets up to speed. Rotation is likely to increase substantially the number of audits which are in the high risk familiarisation phase of their lifecycle. Our analysis suggests that with seven, ten and 14 year mandatory rotation periods, the proportion of audits within the FTSE 350 which are in their first two years will be 28%, 20% and 14% respectively.

(iii) On the basis that new audit firms take at least a year and often two to fully understand the business,[111] on a seven year rotation cycle companies could spend six years in a ten year period effectively "in transition" (including the distraction of holding a tender in the year preceding a rotation).

(iv) While these costs and risks may be justified where a company has gone out to tender and decided that the benefits of switching outweigh the costs, it is not appropriate to force companies to incur such costs and risks where the company considers that switching auditor is not in its interests.

(d) MFR might also have unintended consequences for mid-tier firms: Rather than reducing barriers to entry for the mid-tier firms, rotation may have the opposite effect of forcing the clients of the mid-tier firms to switch (with Big 4 firms the likely beneficiaries, as the CC's

[111] As acknowledged by the CC - see paragraph 9.172.

data suggests)[112] while not providing equivalent or more realistic opportunities for the mid-tier firms to win new large company audits. The CC's statistics show that companies with a Big 4 auditor are substantially more likely to move to another Big 4 firm rather than to a mid-tier firm.[113]

Lost relevant customer benefits

3.43 One of the features that the PFs find to give rise to an AEC is that companies and audit firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of benefits of continuity stemming from the relationship. The PFs expressly acknowledge that these benefits of continuity[114] give rise to beneficial effects for customers (shareholders). As such, these effects must be taken into account by the CC in deciding on the appropriate package of remedies.

3.44 Requiring companies to switch audit firms periodically would impose substantial costs on companies and force companies to give up the benefits of continuity. These detriments could be avoided by tendering under the new FRC regime, coupled with other remedies that strengthen shareholder engagement and AC effectiveness.

Remedy 3: Expanded remit and/or frequency of AQRT reporting

3.45 It is important to maintain the independence of the inspection regime and 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. Subject to this important proviso, we support enhancements to the role of the AQRT designed to improve the ability of companies (acting through the AC) to assess the quality of competing audit firms.

3.46 More regular AQRT reviews of individual FTSE 350 audits would provide companies with more frequent independent reviews of their own audit, and would facilitate greater comparison between the firms. Current AQRT reports only cover a limited number of audits, selected to some extent on a risk basis, and are therefore - as the AQRT itself states - relatively limited in terms of allowing companies to draw overall conclusions.

3.47 To ensure the AQRT process remains cost effective, it may be necessary for the increased frequency of reviews to be combined with a streamlining of the process and scope of the reviews. We believe that the detail of how such a new regime would work and the criteria to be applied are most appropriately left to the FRC following consultation with relevant stakeholders.

3.48 To provide companies with more information about audit quality, we also propose that all audit firms should be encouraged to disclose information in their annual transparency reports. Such information might include, as we already currently provide in our annual transparency reports:

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112 See paragraph 9.26: "*For FTSE 350 companies the observed switching has overwhelmingly been either between Big 4 firms or to a Big 4 firm*."

113 See paragraph 9.26: "*From 2001 to 2010, the CC identified 83 occasions (excluding switches away from Arthur Andersen and instances where a company changed to or from a joint audit) in the public data set when a FTSE 350 company switched auditor: approximately 82 per cent of these switches were from one Big 4 firm to another, and 13 per cent were from a Mid Tier firm to a Big 4 firm. There are three examples of a company switching from a Big 4 firm to a Mid Tier firm, and one of a company switching from one Mid Tier firm to another."*

114 See paragraphs 9.159 to 9.161.

results of the AQRT'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.

Remedy 4: Prohibition of contractual clauses in template documents limiting choice to the Big 4 firms

3.49 To the extent that the existence of such clauses in loan documentation prevents mid-tier firms from being appointed as auditor of a large company, or reinforces a perception that they are unable to compete in that market, we support the CC's proposed removal of such clauses. This will allow all firms to demonstrate their credentials in a tender process. We do not believe that this would be onerous to implement (probably by recommendation to the Loan Market Association to amend their precedents).

Remedy 5: Strengthen accountability of the external auditor to the AC

3.50 We support the objectives of this remedy of (a) increasing the influence of the AC on the external audit process; and (b) increasing the independence of the external auditor from executive management.[115]

3.51 In our experience, there is a strong reporting line between the external auditor and the AC in most large companies, although there is scope for measures to provide absolute clarity that the auditor is accountable the AC. However, it is not correct for the CC to aim to achieve the AC/ACC as being *"solely and unambiguously the client of the AEP"*[116] [emphasis added]. The client of the auditor is the company (acting in the interests of the shareholder) and we do not believe that anything should change this fundamental status.

3.52 Notwithstanding this important point of clarification, we welcome measures to enhance the AC's role in auditor appointment and monitoring by:

(a) reinforcing that the auditor is accountable directly to the AC/ACC (on behalf of shareholders); and

(b) improving the nature and extent of the ACs' understanding of and involvement with the auditor's scope and plan, what issues the external auditor has identified during his or her work, and how these issues have been addressed and escalated (or not) during the course of his or her work (and where relevant how those issues are to be resolved). One way this could be carried out is reinforcing within the existing audit standards the specific nature and extent of communications on these areas.

3.53 Such measures could be achieved by a combination of the FRC issuing suitable guidance to ACs to support the operation of the Code and by enhancements to ISA (UK&I) 260 ". It should be noted that the FRC has recently introduced extended reporting requirements for both

115 RN, paragraph 50.
116 RN, paragraph 48.

auditors and ACs which increase the nature and extent of the matters that auditors are required report to ACs and extend the matters that ACs are required to address in their reports to investors.[117]

3.54 While we recognise the importance of ensuring that the FD does not have undue influence in the selection and oversight of the auditor, it is in our view imperative that this remedy does not have the unintended consequence of preventing the auditor from making all necessary inquiries of the FD and the company's finance team. In this respect, we are concerned by the unintended consequences that might arise from *"the ACC [being] the first point of contact if a material issue arose rather than only being consulted after the Finance Director".*[118] Such a stipulation may well impair the auditor's current ability to obtain or even demand access to full information from the FD and could greatly increase the time commitment required of AC members without significantly increasing their effectiveness.

3.55 Indeed, we note that the FRC states: *"We are concerned with the practicalities of excluding the finance director from these discussions at an early stage. It is unlikely that an auditor will be able to determine whether a matter is an issue or not without detailed discussions with the finance director. Further we should like to explore whether the non-executives would be able to discharge this responsibility and whether the proposals as written threaten the principle of collective board responsibility."*[119]

3.56 A more proportionate and effective direction would be for all material issues to be escalated to the AC for a final decision, when the auditor is fully appraised of the facts necessary to form a judgement.

3.57 We do not believe it is advisable to be overly prescriptive on precisely what auditors are required to communicate to ACs and how they do so. The effectiveness of this remedy requires the AC to gain greater standing and recognition among the investor community. In our view, this is best achieved by expanding the range of issues that should be discussed with the AC; ensuring that management and shareholders understand that the AC is primarily responsible for the appointment and oversight of the auditors; and increasing the AC's visibility (through expanding the content of the AC's report and the role of the AC at General Meetings).

3.58 Therefore, we believe that the enhanced role of the AC is a critical part of the overall package of remedies that should also include:

(a) Greater tendering under the new FRC regime (as explained in remedy 1 above);

(b) Enhanced shareholder-auditor engagement (remedy 6), as part of which:

(i) the ACC might facilitate the AEP's presentation directly to shareholders at AGMs; and

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117 See paragraph 4.32 of the FRC's Guidance on Audit Committees (September 2012). See also the FRC's response to the PFs, page 4.

118 RN paragraph 48.

119 See the FRC's response to the PFs, page 4.

(ii) the ACC might have a dedicated Q&A session at the AGM, to reinforce the importance of the role as a representative of shareholders.[120]

(c) The AC's report might be extended to cover material issues raised by the auditor (remedy 7), again to increase the profile and role of the AC as a representative of the shareholders.

Remedy 6: Enhanced shareholder-auditor engagement

3.59 We welcome measures for auditors to be engaged directly with and visibly accountable to shareholders.

3.60 Of the options proposed by the CC (in addition to greater transparency about the auditor selection process undertaken by the AC and the rationale for the selection decision) we support:

(a) requiring the AEP to present to the shareholders, for example, at AGMs (or other open shareholder forums) on the conduct and outcome of the audit; and

(b) requiring ACCs to have a dedicated Q&A session, for example, at AGMs (or other open shareholder forums) to answer questions on audit or financial reporting.

3.61 We also support the recent change to the FRC Guidance on Audit Committees proposing that companies give greater prominence to their announcement of their intention to hold a tender in advance, thereby providing shareholders with the opportunity to give their views.

3.62 We do not support proposed remedies which would involve:

(a) Changing shareholder voting requirements to include an option for shareholders to vote for holding a tender: In reality shareholders already have this power in the current arrangement in the Companies Act whereby they vote positively each year on the auditor's appointment. A negative vote would lead directly to a tender. Aside from AGMs, investors are able to influence companies (through representations made to the Senior Independent Director (SID), the ACC or to management) in respect of the audit process.

(b) Votes to reappoint the auditor needing an enhanced level of support: This would inappropriately empower minority shareholders to the detriment of the majority. Such enhanced voting powers are normally reserved for major changes in companies' activities and are not appropriate in this case. Moreover, the FRC notes that similar proposals included in its 2011 Effective Company Stewardship consultation received a largely negative response from investors and other market participants[121].

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120 This may be done by amendment to provision E.2.3 of the Code.

121 See page 5 of the FRC's response to PFs.

Remedy 7: Extended reporting requirements - in either the AC's or auditor's report

3.63 We support the extension of reporting requirements about the audit to address unmet shareholder demand.

3.64 The FRC has already increased the requirements on AC reporting in the recent amendment to the Code (building on best practice, which we have been active in leading)[122] and further consultation on audit reporting is in progress by the FRC (as the CC acknowledges) and by the IAASB.

3.65 We support enhanced reporting about audit matters but recommend that this is done through UK influence on the IAASB process rather than a separate FRC solution.[123] International harmonisation of auditor reporting will be more helpful to investors in global markets and it is essential that any remedy in this area recognises that the issues extend beyond the UK.

Remedies not being considered further

3.66 We agree with the CC that the additional measures identified in the RN would be ineffective and/or disproportionate and should not be considered further.

PricewaterhouseCoopers LLP

22 March 2013

[122] As noted in the PFs, at paragraph 7.200, six of our FTSE 100 audit clients - Barclays, GKN, Man Group, Unilever, BG Group and BT - have responded positively to our encouragement by increasing the transparency of reporting on their ACs' activities.

[123] For more detail, please see our section 7 of our response to Remedies Notice (Annex 3).