NON CONFIDENTIAL

12 August 2013

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

Dear Ms Carstensen

**Statutory Audit Services for Large Companies Market Inquiry - response to Provisional Decision on Remedies (PDR)**

We welcome the opportunity to respond to the remedies that the Competition Commission (CC) has proposed for the large company audit market in the UK.

The PDR pre-supposes that the CC's Provisional Findings (PFs) are confirmed in the final decision. As we have explained in our Response to the PFs, and in our responses to the CC's latest working papers on pricing trends, we do not agree with the PFs and dispute that there are features of the large company audit market that lead to adverse effects on competition (AECs), including the CC's assertion that auditors favour management to the detriment of investors. We appreciate that the CC will take these submissions into account before reaching its final decision in this investigation.

We continue to support a package of remedies that:

- promotes competition and choice;
- enhances audit quality and innovation;
- increases transparency between auditors, audit committees (ACs) and shareholders; and
- does not impose a disproportionate burden on companies or firms.

We believe that, with the exception of the design of **remedy 1** (mandatory tendering every five years, with a possible extension of up to two years), the provisional package of remedies proposed by the CC achieves these objectives.

We do not support the design of **remedy 1** to require companies to tender at least every five years because we believe that it would be:

- ineffective by devaluing the tender process;
- unnecessary given that the ten year tender regime is proving effective and is supported by the majority of investors, the FRC and nearly all companies; and
- disproportionate given the substantial additional costs imposed on the market.

pwc

In our view, the provisional AECs would be better addressed by refining **remedy 1** as follows:

- First, the order would require the AC to explain to shareholders one year in advance of the point of the audit engagement partner (AEP) rotation (which period cannot exceed five years) whether or not a tender is to be held at that point. The AC would need to justify any recommendation not to tender at the five year point by explaining to shareholders how the current audit arrangement has been reviewed. This will empower shareholders, via their advisory vote (**remedy 4**), to confirm the AC recommendation or to register their dissatisfaction so that the AC can respond appropriately at the five year point.

- Secondly, the order would require companies to tender at least every ten years with the possibility of explaining a deferral for a maximum of two years (i.e. so that the tender must occur within twelve years). Although we do not believe that mandating tenders is necessary given the effectiveness of the UK Corporate Governance Code (the Code), we recognise that the CC's proposal to limit deferrals to a maximum of two years would enforce good practice.

This refinement to remedy 1 would complement the rest of the remedies package. For example, in exercising its proposed secondary duty to have regard to competition it would be reasonable to expect the FRC to monitor the effectiveness of the tender regime, including the appropriate period of tendering (**remedy 7**). Also, the proposal to increase the frequency of AQR team reports (**remedy 2**) and to increase reporting requirements to include disclosure of AQR team review results (**remedy 6**) would encourage the AC to exercise its discretion over whether to tender at the five year point or at other points in the ten year cycle.

Conversely, there is a serious risk of disenfranchising the AC and investors, and damaging the effectiveness of **remedy 5**, by requiring the AC to hold tenders at five year intervals even where it may be clear that a switch would not be desirable.

We welcome the CC's provisional decision not to adopt mandatory firm rotation. We agree with the CC that any such measure would weaken competition by systematically excluding the incumbent firm from the tender process. We also support the CC's provisional decision not to further constrain non-audit services provision by the auditor; impose joint or major component audits; and the other remedies that the CC has provisionally decided not to pursue.

In the remainder of this letter we set out in more detail why we do not support proposed **remedy 1**.

**Remedy 1 would be ineffective by devaluing the tender process**

- Audit firms must stand a realistic prospect of winning the audit appointment for a tender to be effective. However, this will not be the case under a five year regime for many companies. For example, following a switch of audit firm, the next tender process would start only two to three years after the new audit firm had become fully familiar with the business. Having incurred the time and costs of a thorough tender process and of getting the new firm up to speed with the business, the company would lack incentive to switch again. This would in turn reduce the incentive for audit firms to participate and/or bid aggressively in the tender. This raises a serious risk that many tenders will become compliance exercises that waste the time and resources of both the companies and audit firms involved.

pwc

- Five year periods between tenders will reduce the number of firms able or willing to participate in a tender where they are delivering non-audit services (NAS) to the company. Audit firms will need to develop strategies to maximise the prospect of winning either audit or non-audit service work and this will almost certainly mean that they decide not to participate in certain audit tenders thus reducing choice.

- A five year tender period is likely to lead to de facto five year auditor (re)appointment terms. This is likely to reduce the company's bargaining position at annual (re)appointment relative to the position under ten year tendering, where the company retains the real threat of a tender in the intervening years before the point of mandatory tender.

We also note that an average of at least thirty five effective tenders a year should provide more than sufficient incentive for mid-tier firms to make the investment in their audit practices and provide them with opportunities to present their credentials to prospective companies. These opportunities will also be assisted by the prohibition on auditor selection clauses (**remedy 3**) and the AQR alignment of mid-tier firm reports with other firms auditing FTSE 350 companies (**remedy 2**).

We expand on these points by reference to the PDR in **Annex 1**.

**Remedy 1 is unnecessary because the ten year tender regime is proving effective**

- The FRC's tender regime is proving effective in increasing the number of tenders taking place among FTSE 350 companies. We are expecting fifty FTSE 350 companies to tender in this calendar year and a similar number in the following twelve months. There has been a paradigm shift in the approach of large companies towards tendering and the PDR does not take account of this.

- The ten year tender period is supported by all constituent groups, including the majority of investors, regulatory bodies, companies, audit firms and industry bodies. As the Association of British Insurers explained in their response to the Remedies Notice, for FTSE 350 companies to put their audits out to tender every ten years "*strikes the right balance*". The Investment Management Association confirmed in response to the PDR that "*the majority of investors favour the FRC's proposal for tendering every 10 years*".

- The evidence to the CC summarised in **Annex 2** confirms that a clear majority of investors support a ten year tender period and that there is no significant support, from any quarter, for the CC's proposal to reduce the tender period to five years. The CC has not published the results of the investor questionnaire and therefore we cannot assess the extent to which the summary of views contained in the PDR is representative of the responses received.

**Remedy 1 is disproportionate and would impose substantial additional costs**

- The CC's estimate that the costs of five year tendering will be "*in the region of £10 million*" with an "*upper bound at £30 million*" is a significant underestimate. In particular:

    - The PDR does not acknowledge the significant costs which have been introduced to the market since the start of the investigation from implementing the FRC's ten year tendering

pwc

regime. We estimate these to be around £44 million per annum or 4% of annual FTSE 350 audit fees (of approximately £1 billion per annum).

- We believe that the additional costs of tendering every five years, as compared with at least every ten years, will be around £52 million per annum (5% of fees), significantly higher than the CC's estimates.
- Taken together therefore, the FRC's and CC's tendering changes will add approximately £100 million per annum (10% of fees) to the costs to be borne by the large company audit market. These calculations are explained in more detail in **Annex 3**.
- This figure does not take any account of the substantial disruption and transition costs of more frequent tenders to both companies (given the disruption to the business and senior personnel being distracted from other activities) and audit firms (where senior partners and staff will be diverted from audit work, as well as incurring the expense of recruiting and training additional personnel to engage in the tendering activity).

- These costs should not be imposed on the market in the absence of compelling evidence that such frequent tenders are necessary. In particular, the CC does not attempt to estimate the benefits (over and above those generated by the FRC regime) that it believes outweigh the attendant costs from mandatory five year tendering. The reference to capitalisation of the FTSE 350 and total annual audit fees does not in itself justify any such benefit. We believe that the CC should make a detailed assessment of the net benefits of five year tendering against our proposal for ten year mandatory tendering.

----ooooo---

In conclusion, we believe that with our refinement to proposed **remedy 1**, the CC's package of remedies would be an effective and proportionate means of addressing the CC's provisional AECs. The benefits from an increase in tendering are already being seen under the FRC's ten-year tendering regime. A move to five-yearly tendering would fail to achieve any further benefits and would risk damaging the effectiveness of tenders at substantial additional cost.

We trust that you will take into account this letter and its annexes (including **Annex 4**, where we identify some points regarding the implementation of the remedies package), together with our Response to the PFs and the latest working papers, in reaching your final decision.

Yours sincerely

**James Chalmers**
UK Head of Assurance
For and on behalf of PricewaterhouseCoopers LLP

## Annex 1

## Why mandating five year tenders will reduce their effectiveness

1 The CC has provisionally found that "*when companies go out to tender they fully exercise their bargaining power*".[1] The CC has recognised that tenders are effective because:

(a) companies conduct robust tender processes;[2]

(b) only rarely would firms decline an invitation to tender,[3] potential conflicts of interest are frequently resolvable[4] and companies can expect a choice of at least three Big 4 firms;[5] and

(c) having decided to participate in a tender process, firms have an incentive to take the process seriously and make best efforts to win the engagement.[6]

2 The CC then provisionally concludes in the PDR that "*we do not consider there will be a reduction in the effectiveness of tenders by increasing the frequency of tenders to every five years*".[7]

3 In our covering letter we have explained why we disagree with this provisional conclusion. In this annex, we explain in more detail that the features set out in paragraph 1 above, that currently make tenders effective processes, risk being lost or seriously undermined should tenders be mandated every five years. In particular:

(a) There are circumstances in which it will not be in the interests of a company to switch audit firm at the point of a five year tender. This will reduce companies' incentives to run a thorough and robust tender process at this point.

(b) It will be apparent to competing audit firms that they will not have any realistic chance of appointment in such tenders. Therefore they will not have the same incentives to participate in the tender or to compete aggressively.

(c) Such frequent tendering is likely to reduce the number of audit firms that are able or willing to participate in tenders because firms may be committed to providing, or prefer to provide, NAS to companies. Given independence restrictions, this would preclude such firms from being appointed as the auditor.

(d) Tenders risk becoming expensive compliance exercises. There is a real risk that tenders will no longer signal that a company is seriously considering a switch of audit firm, thereby devaluing tenders.

---

1 PFs, paragraph 9.241.

2 PDR, paragraph 3.125: "*tender processes for FTSE 350 audit engagements were typically structured and thorough processes in which companies seek to provide bidders with the access and information they need to prepare informed proposals; and the selection committee with the information they need to make an informed decision.*"

3 PFs, paragraph 9.22.

4 PDR, paragraph 3.105 and PFs, paragraph 9.237.

5 PDR, paragraph 3.105.

6 PDR, paragraph 3.105 and PFs, paragraph 9.239.

7 PDR, paragraph 3.151(c).

(e) Companies will lose bargaining strength at the annual (re)appointment stage, as the threat of a "mid-term" tender is substantially reduced with only five year periods (in contrast to every ten years, when the threat would be real).

(f) Refining remedy 1 as we have suggested (by mandating tendering every ten years and requiring the AC to report to shareholders one year before the AEP rotation whether or not it is proposing to tender the audit engagement at that point) would be a more effective and proportionate way of preserving the effectiveness of tenders while ensuring that companies regularly scrutinise the audit engagement. This approach avoids damaging a feature of the market that the CC has provisionally found to be working well whilst increasing the engagement of investors in the decision whether or not to tender the audit.

4 Dealing with each of these points in turn below:

## (a) There are circumstances in which a switch of audit firm at five years is clearly not in the best interests of the company

5 Where a large company has held a tender process and has decided to switch audit firm, it is unlikely to be in that company's best interests to switch audit firm again in only five years' time. The exception to this is of course where the new firm has failed to perform to the required standard – where the company would choose to tender without delay to appoint a better auditor – but this ability to tender applies at any point in the audit relationship.

6 We explain below that the significant time and costs involved with: (i) carrying out the original tender process; and then (ii) assisting the new audit firm to become familiar with the company's operations; means that (iii) there is no realistic prospect of the company switching again should it be forced to tender again in only five years' time.

### *(i) The time and cost of carrying out a tender for a large company*

7 The PDR provisionally concludes "*companies' costs would be largely restricted to the opportunity cost of management time in organizing and participating in the tender process*".[8] We believe that this significantly underestimates the real cost and disruption to many companies of conducting a tender.

8 As the PDR reports, Barclays has explained that the tender process can involve very significant disruption to business activities of multinational companies "*due to their scale, depth and geographical spread. It estimated that the cost of a single tender process in terms of man hours for a group the size of Barclays would involve in excess of 200 staff with a total time spent in excess of 1,000 man days <u>over an estimated project time of two years</u>. … this would need to be multiplied by the number of firms invited to tender given that each firm would probably have separate information requirements…*"[9] [emphasis added]. This evidence has led the CC to accept that "*there will be times when the cost to the company of conducting a tender process would be particularly high*".[10] This conclusion is supported by our most recent experience of participating in the tender to win the HSBC audit engagement.

9 In light of this experience, it is clear that there will inevitably be substantial costs associated with holding a tender for many large companies. Indeed, it is expressly acknowledged in the PDR

8 PDR, paragraph 3.150(a).
9 PDR, paragraph 3.96.
10 PDR, paragraph 3.98.

that the "*costs of tendering every five years would be greater for those companies with more complex audit requirements and those subject to stricter independence requirements*".[11]

***(ii) The time and cost of a new audit firm becoming familiar with the business***

10 The PFs acknowledge that on the appointment of a new audit firm, there is an intense period of time during which the firm must quickly familiarise itself with the operations of the company.[12] It can take up to two years for a new audit firm to complete this process. To ensure that the audit firm is able to provide a high quality audit and mitigate the risk of errors in the final report, substantial additional time is required in the early years of the appointment, both by the auditor and by the company.

11 In evaluating the costs for companies of five year tendering the CC has only considered the time and disruption of actually conducting the tender process. The PDR does not take into account the potentially substantial familiarisation costs that the company and the new audit firm would incur if the company switches auditor. While these costs are essentially at the discretion of the company, in deciding whether or not to switch auditor, they are highly pertinent to that company's decision to switch again in five years' time and therefore to the credibility of any tender. We believe that these familiarisation costs should be taken into account in the evaluation of the merits of five-year tender periods.

***(iii) No realistic prospect of the company switching again five years after a switch***

12 The combined time and costs incurred by a company that has conducted a thorough tender process that led to a switch, and then familiarising the new audit firm, are therefore likely to be substantial. It also means that for some companies, the tender process under a five-year regime could be required to start afresh as soon as only one or two years after an audit firm appointed at tender has become fully familiar with the business.

13 In light of this substantial time and cost commitment, many companies are unlikely to wish to switch audit firm again at the five year tender point. Unless the new audit firm is failing to perform, it would be difficult to justify to shareholders why a switch of auditor at this time would be in the best interests of the company. As highlighted by BlackRock, "*[a]udit risk may be highest during the first few years after an auditor transition given the lack of in-depth and historical knowledge*".[13] In these circumstances, the company would not be incentivised to run a thorough or robust tender process at this point in time.

## (b) Audit firms would recognise the reality that a switch at five years is unrealistic

14 Audit firms invited to participate in a tender taking place just five years after a large company has switched audit firm will recognise that the existing audit firm is almost certain to be re-appointed. Indeed, the CC recognises this reality: "*[r]ival firms bidding for an engagement would know that if they succeed in winning the tender process, <u>as the incumbent they would be well placed to win the subsequent tender in a later year</u> if the client had been satisfied with their performance…. <u>[i]n these circumstances, the incumbent will have an advantage</u>*"[14] [emphasis added]. The corollary of this is that in many tenders it will be apparent to competing audit firms that there is no realistic prospect of winning the tender.

---

11 PDR, paragraph 3.158.
12 PDR, paragraph 9.177.
13 BlackRock response to the CC's Remedies Notice, page 2.
14 PDR, paragraph 3.110.

15 The CC has recognised that "*the expected gains from participating in a tender process [that] would be the primary consideration for firms in deciding whether or not to participate.*[15] … *[w]e consider that the gains from winning FTSE 350 audit engagements will continue to give incentives to firms to bid*" [16] [emphasis added]. Where there is no realistic prospect of winning appointment, this means that firms will not be incentivised to participate in the tender or to bid aggressively.

16 The CC should recognise that to force companies to tender at the five year point will lead to some tenders taking place where the company has no real intention of switching and the audit firms invited to tender know this. The CC states that "*We acknowledge that the propensity for companies to switch auditor following a tender process is, on average, likely to be lower when the tender has not been voluntary, and that the expected pay-off from participation would therefore be lower*".[17] We explain in section (d) below that this combination means that tenders held in these circumstances risk becoming expensive compliance exercises.

## (c) More frequent tendering is likely to reduce choice

17 Currently, large companies tend to signal their intention to hold a tender up to two years in advance, in order for bidding firms to ensure that they are independent and therefore capable of taking on the audit if they are successful. The CC acknowledges that particularly for companies subject to sector-specific independence rules, such as banking, identifying and resolving conflicts could be difficult. However, the CC appears to dismiss the concern that five-year tendering might be expected to exacerbate these conflicts, on the basis that audit firms could be expected "*to develop the systems necessary to manage such issues and identify issues quickly when required, and for companies to take such matters into account when awarding NAS contracts to avoid being in a position where choice of auditor is overly restricted as a result*".[18]

18 However, if tenders were required to take place every five years neither companies nor audit firms would have the same incentives to ensure that firms were available to tender for the audit:

(a) companies might decide that the value of certain NAS engagements are more important to them than ensuring that the audit firm would be available to tender for the audit (particularly in circumstances when there was no realistic prospect of switching auditor at that point); and

(b) audit firms might decide to effectively rule themselves out of the tender by taking on such engagements, thereby reducing companies' choice in audit tenders. To the extent that there is no realistic prospect of winning some tenders at the five year point, there would not be any commercial incentive for audit firms to sacrifice long-term NAS engagements in order to remain independent at the next tender.

## (d) Tenders risk becoming expensive compliance exercises

19 Companies forced to conduct a tender at the five year point, particularly where this follows a switch of auditor, are likely to conduct less thorough tender processes and may carry out what is in effect a form of compliance exercise.

---

15 PDR, paragraph 3.109.
16 PDR, paragraph 3.110.
17 PDR, paragraph 3.109.
18 PDR, paragraph 3.115.

***The PDR recognises that tenders will involve fewer firms***

20 The CC has recognised that should five year tendering be forced on companies: "*[i]t is likely that in some instances companies will design tender processes that are more selective and invite fewer firms to compete in them as a result of a more rigorous pre-selection process*".[19]

21 Indeed, and possibly in recognition of this, in calculating the possible costs associated with five year tendering, the CC assumes that there will be only three bidders per tender rather than the average of 3.7 firms that have historically participated in tenders.[20]

22 It is unclear whether the CC envisages that there might be proper tenders (with an average of 3.7 bidders) every 10 years and a less rigorous exercise (with, say, two bidders) at the five year point, or alternatively whether the CC is assuming that there will be systematically fewer bidders in all tenders. Either way, it seems likely that under the CC's proposed remedy of five yearly tenders, some – or even all – tenders will involve fewer bidders and therefore less choice for the company concerned than under the conditions that apply to tenders that are currently conducted in the market.

23 This conclusion is at odds with one of the CC's justifications for five-year tendering, which is that *"it is likely to stimulate increased choice both within the Big 4 and by Mid Tier firms for the provision of audit services*".[21] To the extent that the CC's rationale for this conclusion is underpinned by a view that the increased number of tenders would give more firms the commercial incentives to invest to be able to make a credible bid, this requires all tenders to have a realistic prospect of leading to a switch of audit firm and would be achieved by an average of 35 effective tenders a year.

***Some tenders could be reduced to expensive compliance exercises***

24 It appears highly likely that if the CC mandates that tenders must take place every five years, there will be a number of occasions (in particular, five years after the company has switched auditor) when companies will conduct what is in effect a compliance exercise. For example, one or perhaps two rival firms may be asked to present their credentials and proposal for the audit engagement. The company might use the results of this exercise to put pressure on the existing audit firm to improve its service and/or reduce its price.

25 Such an exercise may be a sensible process for the company to undertake at this point. We propose that if the AC decides not to hold a tender at the point of AEP rotation, it should report this proposal to shareholders a year in advance, explaining why this is the case. This justification might include the results of a benchmarking exercise.

26 However, it is not appropriate, effective or proportionate for the CC to mandate that the company must hold a "tender" that should follow the format set out in any guidance issued by the FRC. This remedy will place companies in an invidious position where they must be seen to be conducting a formal tender whilst in reality having no real intention of switching audit firm, because such a switch would not be in the best interests of their shareholders. This will devalue all tenders as they will no longer clearly signal that a company is seriously considering a switch of audit firm. It will also impose unnecessary costs on the company and audit firms.

---

19 PDR, paragraph 3.150(c).

20 The CC's evidence demonstrates that there is an average of 3.7 bidders in FTSE 350 tenders - see paragraph 46 of the CC's Survey WP and paragraph 145 of the Nature and Strength of Competition WP. In the PFs, the CC found that the majority of FTSE 350 companies considered that they had a choice of at least three Big 4 firms - see paragraph 9.237 of the PFs.

21 PDR, paragraph 3.149(c).

## (e) Companies may lose bargaining strength between tenders

27 We have previously explained to the CC that large companies exert continuous pressure on their existing audit firm to obtain high quality service and competitive fees, underpinned by the threat of tender.[22] As the CC's working paper on Evidence on trends in audit fees confirms, this market dynamic has resulted in:

(a) a decline in real audit fees per hour by between 16.7% and 18.6% between 2006 and 2011;[23]

(b) "very similar" price reductions for companies that have not switched to those that have switched[24] (consistent with the evidence we have provided the CC throughout this investigation);[25] and

(c) roughly stable gross margin per hour over the period 2006 to 2011[26] and roughly stable average fees per hour in nominal terms[27] (while grade mix in audit teams and the industry mix of engagements do not suggest conditions have changed markedly and despite ongoing inflationary pressures on staff costs).[28]

28 By requiring tenders to be held every five years, the CC risks creating a de facto five year audit engagement period. This would endanger the current dynamic of continuous pressure in the context of annual renegotiations and thereby reduce rather than strengthen a company's bargaining position.

## (f) There is a more effective and proportionate remedy that would preserve the effectiveness of tenders

29 We do not accept that five-year tenders would "*increase the bargaining power of FTSE 350 companies both during tenders and in between tenders*".[29] On the contrary, to the extent that tenders risk being devalued because they may no longer signal that the company is seriously considering switching, there is likely to be less choice and reduced competition at the point of tender. Further, the reduced threat of a tender taking place other than at the five year point can be expected to reduce the company's bargaining strength at the point of annual (re)appointment.

30 We believe the risk of devaluing the competitive effectiveness of the tender process can be avoided by refining the proposed remedy 1 to retain the current ten year period (reinforced by making tendering mandatory after a maximum of 12 years), with a requirement for the AC to explain one year before the AEP rotation (most likely four years after the mandatory tender) whether it proposes to tender the audit engagement at that point or why this is not appropriate. This decision would be the subject of an advisory vote, allowing the AC to respond to the views of shareholders at the five year point.

---

22 See Section 2 of our submission of Additional Evidence of Competitive Pressure Outside of Tendering for more detail on how large companies exert continuous pressure on their audit firm to obtain high quality service and competitive fees. This section is supplemented by Annex 1, where we provide a consolidated summary of our MFQ Response to Q87 where we gave a comprehensive illustration of how buyer power is exerted by companies in annual audit fee negotiations.

23 See tables 2 and 3 of the working paper on Evidence on trends in audit fees.

24 See paragraph 27 of the working paper on Evidence on trends in audit fees.

25 See our response to the working paper on the Price effects of switching (15 July 2013).

26 As summarised in paragraph 8(c) of the working paper on Evidence on trends in audit fees.

27 See paragraph 48(c) of the working paper on Evidence on trends in audit fees.

28 See paragraph 48(d) of the working paper on Evidence on trends in audit fees.

29 PDR, paragraph 3.149(a).

31 This remedy would be more effective, less onerous and more proportionate than mandatory five-year tendering because:

(a) Tenders would continue to signal that the company is seriously considering a switch of audit firm. The CC recognises that this is an essential feature of an effective tender but does not recognise that mandatory five year tenders by their nature will inevitably lead to some tenders taking place where there is no serious prospect of switching.

(b) It would avoid the wasted costs of conducting a tender that is in effect a compliance exercise. Such an exercise could be undertaken more cost effectively than under the guise of a formal "tender".

(c) It would provide more than sufficient incentive for mid-tier firms and other Big 4 firms to make the necessary investment in their audit practices, and provide them with opportunities to present their credentials to prospective companies.

(d) It would empower the AC to respond to the circumstances of their individual company and test the audit engagement accordingly. We do not accept the CC's view that focusing competition on tenders *"in which the AC has an influential role … [will] contribute to ensuring that shareholder interests are given appropriate weight."*[30] A proposal not to tender at the five-year point would need to be explained by the AC to shareholders and be the subject of an advisory vote at the AGM. This would lead to more active engagement by the AC with shareholders than forcing the AC to hold a tender with no real prospect of a switch of auditor (which may damage the credibility of the AC in the eyes of shareholders). It is therefore a more effective way of addressing the second provisional AEC.

---

30 PDR, paragraph 3.149(b).

pwc

Non confidential

12 August 2013

# Annex 2

## The clear majority of investors support ten year tender periods

1 The CC states that "*[o]n the appropriate timeframe, the views of investors were mixed*".[1] This is not a fair reflection of those investors' views referred to in the PDR. The clear majority of investors – both in aggregate number but more importantly by the value of funds invested - are in favour of a ten year period. Only a minority of investors support a shorter period, of which only two investor bodies and a small number of investors favoured a five year period.[2] In particular, the main investor representative bodies reported that the majority of their members were in favour of a ten year period:

(a) The Investment Management Association (IMA): The trade body for asset managers who manage £4.2 trillion of assets in the UK (as at December 2011) stated this during the consultation period[3] and reiterated this position on the release of the PDR:

"*[W]hilst a significant minority of investors support tendering every five years, as proposed by the Competition Commission, for the majority this is too frequent a timescale. The tendering process takes up a significant level of resource, time and cost for both businesses and audit firms, and with any new assignment there is likely to be a period of learning. The majority of investors favour the FRC's proposal for tendering every 10 years.*"[4] [emphasis added]

(b) The Association of British Insurers (ABI): With over 300 member companies, accounting for 90% of the UK insurance market (which is responsible for investments of £1.8 trillion in 2011, being 26% of the UK's total net worth), the ABI also supports ten years.[5]

2 The CC has refused our request to publish a detailed breakdown or even a complete summary of the results of the investor questionnaire, instead summarising a limited number of responses in the PDR. The CC has confirmed that 21 investors responded to this questionnaire, but their summary of views in the PDR refers to only four investor questionnaire responses in relation to remedy 1 (those shown in red in footnote 6) and another 14 investor questionnaire responses in respect of other points (those shown in blue in footnote 6)[6].

3 The table overleaf summarises stakeholders' views received by the CC during the course of this investigation on the appropriate period between tenders. It illustrates that the clear majority of stakeholders – across all constituent groups, including investors - favour a period of ten years between tenders. In our view, the reason there is such a strong market consensus to support ten year tendering over five years is because this achieves the best balance in terms of effectiveness and cost.

---

1 PDR, paragraph 3.24.

2 Baillie Gifford; National Association of Pension Funds (NAPF); Newton Investment Management; and a coalition of six investors and a body representing 56 local authority pension funds.

3 See the IMA response to Remedies Notice, page 4.

4 See the press release issued by the IMA on 22 July 2013: www.investmentfunds.org.uk/press-centre/2013/press-release-2013-07-22/

5 See ABI response to Remedies Notice, paragraph 12: "*supported the recent changes to the FRC's UK Corporate Governance Code to require, on a 'comply or explain' basis, FTSE350 companies to put their audits out to tender every ten years. We believe this strikes the right balance and could improve competition.*"

6 Of the list of recipients of the investor questionnaire received from the CC, those highlighted in red were referred to in relation to remedy 1; those in blue were cited elsewhere in the PDR; and those in black were not referred to (making it unclear whether or not they responded to the questionnaire): Aberdeen Asset Management, AllianceBernstein, Alliance Trust Asset Management, Artemis Investment Management, Aviva, AXA Investment Managers UK, Baillie Gifford, Barclays Wealth Management, Barings Asset Management, BlackRock, Brewin Dolphin, Canada Life Asset Management, F&C Investments, Fidelity Worldwide Investments, Friends Life, Henderson Global Investors, Hermes, Invesco Perpetual, JPMorgan Asset Management, Kames Capital, Legal and General Investment Management, Local Authority Pension Fund Forum, M&G Investment Management, MFS Investment Management, Newton Investment Management, Norges Bank Investment Management, Rathbone Unit Trust Management, Royal London Asset Management, RPMI (Railpen), Schroder Investment Management, Scottish Widows Investment Partnership, Standard Life Investments, Threadneedle Asset Management, UBS Global Asset Management (UK), Universities Superannuation Scheme, ABI, CRUF, CFA-UK, Governance for Owners, IMA, NAPF, ShareSoc, PIRC.

## Table: Market consensus in support of ten year tender periods

| | 5 years | 6 – 9 years | 10 years | 10 years + / Other[7] |
|---|---|---|---|---|
| **Investor Representative Bodies** | • USS[8]<br>• UKSA[9] | • NAPF | • ABI<br>• IMA | |
| **Investors[10]** | • Baillie Gifford<br>• Legal & General<br>• Newton Investment Management | | • AXA Investment Management<br>• BlackRock[11]<br>• Hermes<br>• Kames Capital<br>• Royal London Asset Management<br>• Investor [✂][12]<br>• Investor [✂][13] | |
| **Regulators** | | | • FRC | • Canadian Public Accountability Board<br>• FSA |
| **Companies[14]** | • Company K (CFO)[15] | • Nestor Advisors<br>• Company K (ACC)<br>• Company P (GFD)[16]<br>• Company Q<br>• Company T (ACC)[17]<br>• Company W (CAO)[18]<br>• Company U (ACC)[19] | • Aggreko<br>• Barclays<br>• Berkeley Group Holdings<br>• BHP Billiton<br>• BT Group<br>• GlaxoSmithKline<br>• Independent Audit Limited<br>• Lloyds Banking Group<br>• RBS<br>• Rexam<br>• SABMiller<br>• Smiths Group<br>• Smith & Nephew<br>• Tate & Lyle<br>• Company G<br>• Company L<br>• Company N<br>• Company O<br>• Company P (ACC)<br>• Company R<br>• Company S<br>• Company T (GFD)<br>• Company U (GFD)<br>• Company V<br>• Company W (ACC)<br>• Company [✂][20] | • SEGRO<br>• Company M<br>• Proxima |
| **UK Industry Bodies** | | • Chartered Financial Analyst Society of the UK | • 100 Group<br>• BBA<br>• CBI<br>• GC 100<br>• ICAS<br>• ICAEW<br>• CIMA | • Loan Market Association<br>• NAO |
| **Non UK Industry Bodies** | | | • South African Institute of Chartered Accountants | • AFME<br>• Chartered Professional Accountants of Canada<br>• Confederation of Swedish Enterprise and FAR<br>• Hong Kong Institute of Certified Public Accountants<br>• Institute of Chartered Accountants Australia<br>• International Federation of Accountants |
| **Individuals** | | | • Simon Laffin[21] | • Prof. Dr. Annette Köhler; Keith Potts; Tony Shearer; Martin Thornhill; Garry Watts; Nick Land |

7 Please note that this column includes parties who did not express a view as regards timing of tenders.
8 Together with a coalition of six investors and a body representing 56 local authority pension funds. This group, together with L&G and Newton Investment Management, support a period of 5-7 years (PDR, A3(1)-24).
9 UKSA did not express a specific view but indicated strong support for USS' position (i.e. for 5-7 years).
10 In the cases of Baillie Gifford, Newton Investment Management, AXA Investment Management, Royal London Asset Management and the two redacted investors, the source for this evidence is their responses to the investor questionnaire which were selected by the CC for inclusion in the summary in PDR, A3(1)- 23/24.
11 Blackrock did not express a specific view but indicated support for the IMA's position.
12 Investor [✂] was not clear why tendering more frequently than every 10 years would create a notable benefit (PDR, paragraph 73, A3(1)-23).
13 Investor [✂] said it was not obvious that 5 or 7 year period was the best period (PDR, paragraph 74, A3(1)-23).
14 In the cases of Companies K, P, T, U and W there was some difference in opinion between the ACC/GFD/CFO/CAO (as relevant).
15 The CFO thought holding a tender every 5 years was about right, while the ACC would recommend going to tender every 5 to 10 years.
16 The GFD would not want to tender more frequently than every 6 years and cited the potential for a negative message to shareholders, while the ACC thought 10 year 'comply or explain' FRC rule was satisfactory for the company.
17 The ACC, unlike the GFD, thought a 6 year period between tenders was reasonable.
18 The CAO considered tendering more frequently than 7 to 10 years would create substantial costs, while the ACC wanted to give the FRC regime more time to take effect.
19 The ACC wanted the AEP rotation to be 7 years and auditor tendering to be linked, while the GFD thought tendering every 10 years was reasonable.
20 Company [✂] supported the new FRC provisions, paragraph 11 (PDR, paragraph A3(1) –3).
21 Chairman of a UK listed company and ACC for two UK listed companies.

# Annex 3

## How the CC has materially underestimated the costs of five-year tendering

1 In this annex we explain how the CC has materially underestimated the costs associated with the proposed remedy of mandatory tendering every five years. The CC has estimated "*the upper bound of incremental costs associated with this remedy, including to companies and to firms, at £30 million a year*" with the CC expecting "*actual incremental costs to be significantly lower than that, perhaps in the region of £10 million a year*".[1] This range is a significant underestimate and we explain below that the CC has not:

(a) correctly calculated the additional costs of tendering every five years, as compared with at least every ten years;

(b) acknowledged the significant costs which have been introduced to the market since the start of the investigation from implementing the FRC's ten year tendering regime; and

(c) taken proper account of the costs of disruption for both companies and audit firms.

2 We explain our position on each of these points below.

## (a) Incremental costs of tendering every five years rather than every ten years

3 In the PDR, the CC has only estimated the incremental costs of tendering every five rather than every ten years and found that the incremental costs could be as high as £30 million. This calculation is based on an increase of 35 in the average annual number of tenders (i.e. to 70 from 35 per annum) at a cost of £225k (based on the CC's analysis of historic tender data) for each of three audit firms bidding in each tender, plus what appears to be an implicit assumption that the total cost for companies of conducting 35 additional tenders would be less than £6.4 million (equivalent to £182k per company per tender). The CC considers that in practice the incremental costs could be as low as £10 million.

***The flaws in the CC's calculations***

4 There are a number of flaws in the way in which the CC has calculated the figure of £30 million per annum:

(a) It is calculated at historic 2005 prices.

(b) It is based on the CC's analysis of historic tender data which was also during a period when smaller than average companies were tendering.

(c) It underestimates the number of companies that are likely to be affected by the CC's proposed order.

[1] PDR, paragraph 3.152.

5 We have carried out this same calculation:

(a) Increasing the CC's figure of £182k per company by 25% to take account of inflation.[2] This adjustment increases the figure to £228k per company.

(b) Using data on our own experience of tender proposals for 2011 to 2013. These tenders are more recent than those analysed by the CC. They also took place during a period when a more representative sample of companies appears to have been tendering their audits than in the more historic past. Our analysis shows that since 2011, there have been five out of 27 tenders (19%) from the FTSE 50 (of which two (7%) were from the FTSE 25). By contrast, from 2007 to 2011 there was only one out of 25 tenders (4%) in the FTSE 50. Our experience indicates that the average cost per tender to a firm is £360k per firm as compared with the CC's figure of £225k (in 2005 prices).

(c) Making the conservative assumption that the CC's proposed order is likely to affect 400 rather than 350 companies, given the rate of turnover of companies in the FTSE 350 and how the CC recognises that the FTSE 350 is a "shifting class".[3] We therefore gross-up the figures described above by 400/350.[4]

6 This calculation indicates that the incremental cost of moving to a five year tendering regime from the existing ten year regime would be about £52 million per annum (or 5% of annual total audit fees[5]).

***The level of costs in practice***

7 The CC believes that in practice the incremental costs involved in tendering every five years could be as low as £10 million. This figure is rationalised on the grounds that:

(a) Partners and senior staff will no longer need to spend time developing relationships with company management in order to encourage companies to go out to tender.[6]

(b) Tenders will be spread out over time and carried out during audit firms' "quiet periods".[7]

(c) Companies and firms will generally become more efficient at tendering.[8]

---

2 Average prices rose by about 25% between 2005 and 2013 according to the UK Consumer Price Index (CPI), the index the CC appears to use. The CC recognises this point in PDR paragraph 3.82 but then discusses a potential conversion into 2011 prices rather than 2013 prices.

3 PDR, paragraph 3.167.

4 Our infographic shows that in the six quarters to June 2013 there were: 20 new "first time" entrants; 16 listed companies which returned to the index; 8 which left due to takeover and de-listing; and a number of other companies which left but are likely still to require tender. Thus, even in this short space of time we can see that the number of companies affected by the Order will be substantially higher than 350 (i.e. 350 + 20 + 16 – 8 = 378).

5 The phrase "total annual audit fees" refers to the annual audit fees of the 400 largest companies in 2013 prices, which we estimate to be £1.03bn (i.e. £817.3m x 1.10 x (400/350)). The components of this calculation are as follows:
(a) £817.3m is total FTSE 350 audit fees in 2010 according to the CC's Provisional Findings, Appendix 5 ('Descriptive Statistics'), Table 2;
(b) 1.10 reflects the increase in prices between 2010 and 2013 according to the UK Consumer Price Index (CPI), the index the CC appears to use to compare prices (PDR paragraph 3.82); and
(c) (400/350) approximately adjusts for 400 rather than 350 companies.

6 PDR, summarised at paragraph 3.83(c) and paragraph 3.84.

7 PDR, summarised at paragraph 3.83(b).

8 PDR, summarised at paragraph 3.83(a).

8 We do not agree with this rationale because:

(a) It will not be possible to simply divert partners and senior staff to tenders from marketing activities. This fails to recognise the depth of knowledge of the company and the sustained focus that is typically needed to win a tender. It is more likely that marketing activity by partners and senior staff will need to be increased in order to be able to make credible bids in more tenders in the future.

(b) Partners and senior staff do not have a "quiet time" in the working year, given that companies have different year ends and to the extent that staff are not engaged on audit work they are involved in essential activity such as training (which is required for their personal development and by our regulators) and compliance activity. Analysis of our staff time suggests that senior personnel (from partner through to manager) record substantial amounts of overtime throughout the year.

(c) While we may well become more efficient as we take part in more frequent tenders, our experience is that audits and audit tenders are highly bespoke and designed for individual company needs – all of which suggest that the scope for additional efficiency is limited.

## (b) Costs introduced to the market of tendering every ten years

9 The CC's approach does not include an assessment of the very significant tendering costs that are already beginning to be incurred as a result of the FRC's ten year tendering regime. This is important because the CC assessed competition in the market prior to this change, and is therefore assessing how best to address the AECs that it considers to exist based on that assessment (rather than an assessment which incorporated the FRC's tendering regime).

10 We explain below that applying the CC's methodology to these costs but amended to take account of the factors referred to in paragraph 5 above - suggests that the CC has omitted from its analysis costs of around £44 million per annum (or 4% of total annual audit fees).

11 This calculation is based on the following components:

(a) An increase in the average annual number of tenders of 24.4 (i.e. from an average of 10.6 per annum to 35 per annum).

(b) Costs per company (£228k) and per audit firm bidding in each tender (£360k) as calculated above.

(c) The same assumption about the number of companies that will be affected by the Code.

(d) An assumption that there will be an average of 3.7 bidders (rather than three bidders) per tender because we expect that ten year tendering will result in tenders that are similar in participation and intensity to those observed in the past.

12 In summary, correctly applying the CC's methodology means that, compared with the historic market that the CC investigated and in which it identified provisional AECs, its provisional remedy of tendering every five years is likely to result in costs of some £100 million per annum (£96 million per annum on the above calculations) (or 10% of audit fees). This figure is substantial and does not take into account the significant costs of disruption that will be incurred by both companies and audit firms when

they are engaged in substantially more frequent tenders, as we explain below.

## (c) Costs of disruption for companies and audit firms

13 We explain below that there are substantial costs of disruption for both companies and audit firms associated with doubling the frequency of tendering. These costs should not be imposed on the market in the absence of compelling evidence that such frequent tenders are necessary.

***Companies***

14 The PDR finds that "*companies' costs would be largely restricted to the opportunity cost of management time in organizing and participating in the tender process*,"[9] which we do not believe places sufficient weight on the potentially significant level of disruption five year tenders could impose on companies.

15 The CC has provisionally found that "*tender processes for FTSE 350 audit engagements were typically structured and thorough processes in which companies seek to provide bidders with the access and information they need to prepare informed proposals; and the selection committee with the information they need to make an informed decision*".[10] It is therefore clear that companies take tenders seriously and this involves a substantial commitment from senior people. Particularly where the company has appointed a new audit firm at the previous tender, requiring senior personnel to make a serious time commitment to a tender that is unlikely to lead to a further switch can be expected to lead to dysfunction as those personnel will be aware of resentment from the individuals involved that their time could be better spent in the interests of shareholders on other activities.

16 The fact that the CC has found that it "*could not put a reliable monetary value on this time*"[11] should not lead to these significant costs being overlooked when evaluating the true cost to companies of more frequent tendering. In the long run we would expect companies to recruit and train additional senior personnel in order to deal with more frequent tendering. The costs of doing this could be substantial.

***Audit firms***

17 In the short to medium term, senior audit firm personnel involved in the additional tender activity would be diverted from audit work. This would otherwise be profitable client work and therefore involves a real cost for the firm, which the CC should take into account in evaluating the costs involved. Over time, audit firms will need to identify, recruit and train experienced and senior people to undertake business development activity and tenders and/or to undertake existing audit work where current staff have limited capacity because of their involvement in additional tenders.

## Conclusion

18 It is clear that even the CC's upper bound of costs to companies and to firms of £30 million a year is a significant underestimate of the costs associated with the proposed remedy of mandatory tendering every five years. When properly adjusted for the additional costs that will be imposed from a move to

---

9 PDR, paragraph 3.150(a).
10 PDR, paragraph 3.125.
11 PDR, paragraph 3.92.

every five years from at least every ten years and the already significant costs introduced to the market since the start of the investigation from implementing the FRC's ten year tendering regime, tendering every five years is likely to result in costs of some £100 million per annum, excluding the cost of disruption to companies and audit firms.

19 In addition, the CC does not attempt to estimate the benefits that it believes outweigh the attendant costs from tendering on a five yearly basis. Referring to the capitalisation of the FTSE 350 does not in itself justify five year tendering in the face of these costs, and before proceeding with this remedy the CC must properly assess both the full costs it would impose and the extent of the claimed net benefits of five year tendering (as compared with our proposal for ten year mandatory tendering).

# Annex 4

## Comments on implementation of the remedies

1 We have explained in our covering letter that we support the proposed remedies package with the exception of the CC's proposed remedy 1 (which we believe should be refined to require companies to tender at least every ten years, with the AC proposing to shareholders how the audit engagement is to be tested at the point of AEP rotation). Below we identify some points concerning the implementation of the remedies for the CC's consideration in finalising the remedies package:

**Remedy 1 in relation to "open book" tendering**

2 We have previously outlined our concerns with "open book" tendering should this oblige the existing auditor to make available its working papers, or the company to share the full audit plan and other highly sensitive documents.[1] We therefore welcome the CC's provisional view that "*companies should have the power to request that the incumbent firm disclose only specified parts of the file which would provide rival firms with information specific to the audit and which would not compromise the commercial confidentiality of the company or firm or the intellectual property of the incumbent firm*"[emphasis added].[2]

3 The proposed order should include sufficient safeguards to protect confidential and sensitive material belonging to the incumbent audit firm as well as to the company. This is important because while the company can be expected to identify material that contains sensitive information about the company, it may not be able to judge what material is commercially confidential to the incumbent audit firm or which risks compromising the incumbent audit firm's intellectual property rights.

**Remedy 4: Enhanced shareholder engagement**

4 In making any changes to the UK Corporate Governance Code and to the Stewardship Code, it will be important to ensure that appropriate wording is recommended. For example, in the CC's suggested change to the Stewardship Code, it is incorrect to infer that the ACC is part of management.[3]

5 The CC should take into account the proposed new disclosures required to be made by the AC under the Code and by auditors under ISA (UK&I) 700, effective for financial reporting periods beginning on or after 1 October 2012 (that is, for 30 September 2013 year-ends). This requires the AC and auditors of entities complying with the Code to provide further information to shareholders about aspects of the audit, allowing greater shareholder engagement with the ACC and company at the AGM.

**Remedy 5: Strengthening the accountability of the external auditor**

6 We consider that the CC's proposal in paragraph 3.422 that "*the auditor should report any audit issue that the AEP considers to be material as soon as is practicable to the AC/ACC, having established the facts of the issue with the relevant finance and other staff*" may not be necessary in light of the following recent and proposed regulatory changes:

---

1 See our response to the PFs, paragraphs 3.34-3.36.

2 PDR, paragraph 3.144.

3 PDR, paragraph 3.346: "*holding additional meetings with management,* ***including Audit Committee chair and members***" [emphasis added].

(a) The recent changes to ISA (UK&I) 260, also effective for financial reporting periods beginning on or after 1 October 2012, require the auditor to communicate to the AC relevant information to enable them to understand the rationale and the supporting evidence the auditor has relied on when making significant professional judgments in the course of the audit and in reaching an opinion on the financial statements. The standard includes a prescriptive list of matters that the auditor must communicate, which in our view clearly addresses the proposed CC remedy.

(b) Furthermore, proposed revisions to ISA 260 recently proposed by the IAASB, which following precedent will likely be adopted into the ISA (UK&I), would explicitly require that the auditor must communicate significant risks identified to those charged with governance. Any significant risk not identified at the planning stage of the audit, but subsequently arising during the engagement, would need to be communicated.

**Remedy 6: Extended reporting requirements in the AC's report**

7 We support the extension of reporting requirements of the AC report to include reference to any AQR team report on the company's audit. However, we are concerned that, as currently constituted, detailed disclosure of AQR team findings may have inappropriate negative repercussions for the company concerned. Indeed, the AQR team's mandate is to identify areas of improvements: "*The [AQR team] seeks to identify areas where improvements are, in its view, needed in order to safeguard quality and/or comply with regulatory requirements and to agree action plans with the firms designed to achieve these improvements. Accordingly, the [AQR team]'s reports place greater emphasis on weaknesses identified requiring action by the firms than areas of strength and are not intended to be a balanced scorecard or rating tool*" [emphasis added].[4]

8 In order for the AQR team's report to be understood and considered by shareholders in context, it may be necessary for the AQR team to consider carefully how changes should be made to the current reporting process.

[4] See *"Appendix A - Inspection process and basis of reporting"* of all AQR Team's Annual Reports.