
PwC's status update on the Competition Commission's Statutory Audit Investigation

PwC outlines key concerns with Provisional Findings and details support for a package of remedies that support quality, transparency and competition and enfranchises shareholders

The Competition Commission's (CC) investigation into the market for audit services is reaching a critical phase as it holds hearings on its Provisional Findings and Remedies Notice with various parties and moves towards publishing its final report (due in September 2013). The importance of the investigation cannot be overstated given its relevance to discussions around the world, and in Europe in particular, and the fact that remedies will reflect an eighteen month market analysis. The UK outcome will doubtless be looked at closely by others.

It is therefore important that the issues raised by the investigation are properly understood and that all stakeholders contribute to the debate. That includes PwC being very clear where we stand.

We have some serious reservations about the process so far but nevertheless believe that changes could and should be made to further underpin audit quality, improve transparency and reinforce competition. We have proposed a far reaching and ambitious package of changes, including many of those suggested in the Remedies Notice. Taken together with the full impact of the September 2012 changes to the UK Corporate Governance Code in relation to tendering, they would respond proportionately to the evidence that the CC has gathered and drive competition and transparency without damaging quality or reducing the incentives for ongoing innovation. In summary we should:

- strengthen the accountability of the auditor to the audit committee,
- enhance communication between shareholders, auditors, and audit committees,
- put a greater focus on examining and reporting audit quality; and
- remove any artificial barriers impeding competition.

Our concerns with the Provisional Findings

In the Provisional Findings the CC asserts that auditors "compete to satisfy management rather than shareholder demand" and that there are "significant, persistent and widespread concerns regarding the quality of audits". We don't believe this is the case.

It is true that a principal (shareholder)/agent (auditor) construct creates a theoretical risk that interests could be misaligned. But that is precisely why our duties as auditors, which are enshrined in law, and the standards to which we are held accountable, which are written by independent regulators, have developed in the way that they have and continue to evolve to control the risk. They are rigorously enforced. The evidence gathered by the CC showing these controls work is being ignored. The professional relationships we have with management are essential if we are to do our job properly for the shareholders.

We recognise that quality can always be improved; we are not perfect and an audit is a complex aggregation of processes, facts and judgements. Our independent regulator, the Financial Reporting Council (FRC), produces its own inspection reports and recognises that audit quality continues to improve but there are opportunities to go further, and we focus a lot of time and energy responding to any quality issues that arise. It is unclear what evidence exists to support the CC's statements.

For the CC to link these two erroneous statements, alleging a lack of independence and poor audit quality, with a possible remedy of mandatory rotation or frequent short tenure mandatory tendering, without having evaluated the benefits of the introduction of tendering at least every ten years on a comply or explain basis, is just not justified by the evidence presented by the CC.

A package of remedies that strengthens quality, transparency and competition and enfranchises shareholders

PwC supports a package of remedies that will build on the tendering changes recently introduced by the FRC and enfranchise shareholders and audit committees whilst strengthening quality, transparency and competition. It will result in significant changes in the FTSE 350 audit market.

Measures should be taken to:

1. Strengthen the accountability of the auditor to the audit committee:
 - a. Reinforce the audit committees' importance and get all audit committees to perform and report as the best do today;
 - b. Extend the externally facilitated board effectiveness review, required for each company every three years under the FRC's Governance Code, to expressly cover and report on the audit committee.
2. Enhance communication between shareholders, the auditor and the audit committee:
 - a. Expand the auditor's report to provide greater insight for the shareholders as well as retaining the binary true and fair conclusion which they tell us is vital – discussions with both UK and international standard setters are well advanced.
 - b. Create and encourage more discussion between the shareholders, the audit committee and the auditors at the AGM.
3. Put a greater focus on reporting audit quality:
 - a. Potentially expanding the remit of the FRC's scope of regulatory inspections. There may also be benefit in the FRC having a secondary objective to have regard to audit market competition.
 - b. Improving existing market communications about audit quality such as audit firms' transparency reports. Transparency reports on audit quality should be made more consistent with enhanced content, to increase comparability between firms, and their profile raised with investors and other market stakeholders
4. Remove artificial barriers impeding competition and in particular clauses in any documents limiting choice to the Big 4 firms.

However, we strongly oppose mandatory firm rotation and short term mandatory tendering because these measures would disenfranchise shareholders, are not justified by the evidence and appear to be directly opposed by those responsible for regulation of the market.

Mandatory firm rotation, however long the period, directly reduces competition by eliminating at least one firm from the tender process, could deny the shareholders the right to elect their auditor of choice should that be the incumbent, and could damage quality if companies were forced to change in high risk situations.

We agree with the FRC that its new tendering regime, on which it consulted widely prior to implementation, is already having an impact on the market. It should be given time to become established. An audit committee must retain the ability to act in the best interests of the shareholders having regard to a company's particular circumstances. The comply or explain regime is both well understood, effective and one of the strengths of the UK corporate governance regime. It shows a willingness to embrace transparency and give investors the information they need to make key decisions rather than stifle innovation and experimentation through over-regulation. Those outside of the UK see the benefits of focussing on principles rather than rules and requiring complete transparency where a principle is not followed so that shareholders can react as they see fit. In fact some 97% of the Code requirements are complied with.

A tendering frequency of less than ten years runs serious risks of:

1. Significantly reducing the likelihood of tenders within the specified period, which could increase audit firms' security of tenure irrespective of individual circumstances, thereby reducing the competitive pressure for a quality service every year;
2. Reducing the effectiveness of tenders because companies and their shareholders do not see them as an event that gives rise to a real prospect of change. If the period between tenders is too short the disruption and costs which are recognised by the CC become an even more major deterrent to change.
3. Reducing incentives to win and thus making bidders reluctant to take on the cost and distraction of tenders with little or no prospect of new work. Such efforts would also absorb valuable partner and staff capacity which would otherwise be focussed on delivering high quality audits.

It is better to let the carefully crafted changes to the Code take full effect.

Conclusion

PwC has been and remains very supportive of changes that drive improvements in audit quality, increase transparency, underpin competition and focus on empowering shareholders to make important decisions about their company. We do not believe in disenfranchising the owners of the company through externally mandated actions.

We will continue to engage in an active and constructive dialogue with both the CC and other market participants. The CC's investigation is in a critical phase and the issues involved are important for investors and companies - we encourage all stakeholders to make their views known to the CC.

For further information or to discuss these issues, please visit our website:

<http://www.pwc.co.uk/trust/issues/statutory-audit-services-for-large-companies-market-inquiry.jhtml>

or contact Richard Sexton or James Chalmers.

PwC

8.5.2013



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