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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.

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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.

- 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

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.

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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