Case studies 2: tendering and switching—consolidated summary

Introduction

1. Following the publication of the Remedies Notice, CC staff held a series of conversations with CFOs (or equivalent) and ACCs with the aim of probing the effectiveness and proportionality of the remedies for the promotion of more frequent tendering and switching by companies of their audit engagements.

2. The companies were selected from the FTSE 350 index. The criteria for selection were: the companies had recently voluntarily tendered and in some cases had switched their auditors (enabling the CC to improve its understanding of the costs and benefits to companies of tendering and switching), companies that had switched auditor on the occasion of a merger or acquisition, companies intending to tender, and companies that had explicitly stated they would not be running a tender or had publically expressed concerns about the cost of tendering.

3. During the course of the case studies, the CC spoke in all to 25 CFOs (or equivalent) and ACCs, selected on the basis of their association with 15 FTSE 350 companies,[1] about their views and experiences with tendering and switching auditor (as well as on other possible remedy options). In addition to the case studies, the CC also held a hearing with Nick Land, a former Chairman of a Big 4 firm and now ACC of three major multinational companies, with the aim of probing the effectiveness and proportionality of remedies more generally. The following paper draws together the views expressed in the case study interviews.

[1] In some instances we spoke only to one of the ACC or the CFO.

4. Among the case study companies, 11 had held a tender over recent years. Six companies had switched auditors, with a further two, following an acquisition or merger, appointing an incumbent auditor with a wider remit covering the whole merged company. In addition, those interviewed were in some cases able to draw on experiences earlier in their careers of tendering and switching at other companies.

Tendering: motivations

5. Decisions to go out to tender at six of the 11 companies that did so were influenced by developments in 'good governance' practices, specifically the provisions for tendering every ten years on a comply or explain basis introduced in October 2012 into the FRC Corporate Governance Code, as well as by the wider attention being currently directed towards the regulation of the audit sector, including by the CC.

6. This influence was particularly strongly felt by those interviewed from global financial groups and other large multinationals, who argued that changing auditors was extremely difficult in view of the complexities of the companies' businesses (see paragraph 62).

7. Two worldwide banking groups told the CC that the new corporate governance provisions were exerting strong influence on their thinking about tendering.[2] One (Company G) said that it would in due course be making a decision to hold a tender in line with FRC recommendations.[3] The other (Company R) stated that it intended to tender for the external audit 'in light of the requirement to tender the external audit every ten years on a comply or explain basis';[4] the ACC of Company R added that there was a general drive to increase levels of tendering given external pressures

[2] Case Study G and Case study R.
[3] Case Study G, paragraph 1.
[4] Case Study R, paragraph 2.

about perceived ‘coziness’ and the financial crisis. He saw little other reason as the company had been very satisfied with the audit service that it had received.[5]

8. The ACC of Company Q, an energy group, had on assuming the post raised the issue of a tender on good governance grounds.[6] The ACC of Company O (active in over 50 countries) said that the possibility of a tender would be on the agenda of the next AC meeting for the first time.[7] Nick Land, ACC of three FTSE 350 companies, sensed that there was a real momentum for tendering at present, that the FTSE 350 would comply with the Corporate Governance Code requirement to tender every ten years and that there would be many early adopters.[8]

9. However, as the ACC of Company U said, it would generally seem to be hard to persuade a company board to agree to tender for reasons of corporate governance alone.[9] CFOs and/or ACCs of at least five companies had been dissatisfied with the performance of an incumbent auditor and had seen a tender as a way to bring a fresh approach to those company’s audits. Several companies perceived that they were not getting value for money from their long-serving auditors, and had gone out to tender to test the market or specifically to make cost savings. In several cases, the companies, while not dissatisfied with the incumbent, wanted to benchmark audit standards and price and some found that holding a tender had been beneficial even when the incumbent firm was re-engaged. In a couple of cases, companies decided on an early tender so as to gain a strategic advantage in the face of wider developments affecting the audit industry. The following paragraphs enlarge on each of these perceived benefits.

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[5] Case Study R, paragraph 24.
[6] Case Study Q, paragraph 1.
[7] Case Study O, paragraph 16. Nick Land ‘felt there was a real momentum for tendering at present and that the FTSE would comply with the Corporate Governance requirement (for 10-year tenders ... he was aware of several Boards that had decided to initiate tenders without yet informing the incumbent auditors of the decision’.
[8] Meeting with Mr Nick Land, paragraph 4.
[9] Case Study U, paragraph 26.

Dissatisfaction with incumbent auditor

10. Dissatisfaction with the performance of an incumbent often flowed, not from the technical skills of longstanding incumbent auditors, but from a complacency in their approach after many years (in one case over 20) in the role. In these cases, the companies issued a tender with the aim of getting value added from the audit.

11. Company K's ACC explained that the company had not been completely satisfied with the audit service it was receiving, but due to changes in the shape of the Group, and an appointment of a new CFO, the combination of risks associated with switching earlier were too great and the tender was delayed.[10]

12. The implication in the evidence from Company T was that the company had for some time put up with an increasingly complacent approach from its auditor, who had been in the position for over 20 years, despite some efforts to negotiate an improvement. The ACC felt the audit had become commoditized and a routine exercise.[11] The company's decision to issue a tender 'was based on a desire for its auditor to 'add value' to the business by providing useful commercial feedback and going beyond solely providing the audit service. The GFD had a general sense that the incumbent had become complacent with respect to the overall level of service provided. When the incumbent failed to respond to the company's requests to improve the service provided, the GFD decided to test the market'.[12]

13. At Company U, there had been some concern about some aspects of the performance and quality of the incumbent auditors, who had been in place for a decade.[13] The ACC said that the incumbent was not considered to be strong in the relevant sector in the geographical areas in which the company had set up

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[10] Case Study K, paragraph 19.
[11] Case Study T, paragraph 20.
[12] Case Study T, paragraph 4. See also Company V, paragraphs 1 & 7.
[13] Case Study U, paragraph 1.

operations and that the company was not convinced that the AEP was giving sufficient time to the company. The company was looking for a more challenging audit.[14] The ACC noted that had there been no concerns about quality, the drive to go to tender would have been lower.[15] The GFO implied that these concerns had been present for some time stating that although these concerns had been discussed with the incumbent at annual reviews, the decision was taken to test the market.[16]

14. Similar issues were identified at two companies at which those interviewed had previously worked. Company L's CFO recounted that he had lost faith in the credibility of a previous companies auditor's accounting and the regulator had encouraged the company to retender the audit engagement.[17] When working as Chief Executive previously, the ACC of Company M recalled that there had been some concern about the performance of the company's longstanding auditor and the company considered the time was right to put the engagement out to tender.[18]

15. However, not all companies saw diminishing returns from longstanding auditors. The ACC of Company P, speaking of experience as CFO of another company, said that there had been no compelling reasons to change a long-serving auditor; stating that if anything the quality of the team had improved over time.[19]

Cost savings

16. About half the case-study companies perceived that they may not have been getting value for money from their long-serving auditors and this had prompted the decision to go out to tender to test the market. The interviewees from Companies O and L had

[14] Case Study U, paragraph 12.
[15] Case Study U, paragraph 13.
[16] Case Study U, paragraph 1.
[17] Case Study L, paragraph 8.
[18] Case Study M, paragraph 15.
[19] Case Study P, paragraph 22.

found, that audit fees were high for a company of their size.[20] The GFD of Company P said that going to tender would almost always reduce the fee.[21] The CFO of Company K said that tendering put the most intense pressure on fees.[22] Other companies confirmed that there had been intense price competition between firms bidding for an engagement.[23]

17. For several companies the level of the fee was an important factor.[24] Several reported proportionately large initial savings following a tender, of the order of 50 per cent (Company P),[25] 35 per cent (Company L),[26] 25 to 30 per cent (Companies K,[27] S[28] and V[29]), and [✂] per cent in the case of Company T.[30] But there were two reservations noted about offered reductions:

(a) First, it was not necessarily the case that these savings were retained after successive annual fee negotiations. Some negotiated fees might be fixed for a period (eg for three years, as at Company K[31]) but even so many were subject to adjustments (eg for changes in the scope of the audit, as at Company P).[32] The experience of the GFD of Company T was that the benefit of the first-year fee reduction dissipated by the third year of the new auditor's tenure. This was the result of organizational changes which changed the scope and resulted in fee rises. In addition the auditor might seek to renegotiate fees to take account of any unforeseen complexities. All of which meant that comparing a like-for-like audit fee was difficult.[33]

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[20] Case Study O, paragraph 2; Company L, paragraphs 2 & 17.
[21] Case Study P, paragraph 9.
[22] Case Study K, paragraph 6.
[23] See, for example, Case Study P, paragraph 9.
[24] For example, Case Study K's CFO 'discounted one firm as, although the cheapest, it was the least competent of the firms and the CFO was not prepared to accept that level of quality despite the lower fee. He discounted another firm as it was more expensive than the incumbent auditor and the now current auditor, but offered the same level of quality'.
[25] Case Study P, paragraph 8.
[26] Case Study L, paragraph 3.
[27] Case Study K, paragraph 6.
[28] Case Study S, paragraph 12.
[29] Case Study V, paragraph 14.
[30] Case Study T, paragraph 14.
[31] Case Study K, paragraph 6.
[32] Case Study P, paragraph 6.
[33] Case Study T, paragraph 14.

(b) Secondly, ACCs expressed some concern that low bids by firms might lead to reduced services. The ACC of Company N said that rather than putting on any pressure for a lower fee, the ACC was more concerned that the fee was sufficiently large to ensure the auditor's job was properly done, and sometimes spoke to the AEP about this.[34] The ACC of Company Q noted that all the bidders shaved their offers, but this raised some concern that the bids could have been too tight to allow the firm to provide the necessary level and scope of service.[35] ACCs generally—for example of Companies R[36] and U[37]—saw a major part of their role to be to ensure that the fee was sufficient to uphold audit quality. The CFO of Company L, arriving at the company after a quick and dirty tender, was not happy with some of the reporting treatments. He thought the control environment was not as strong as it should be and that the audit fee might have been pushed down too far.[38] Nick Land said that his biggest fear stemming from increased tenders was fee lowballing. As an ACC his first priority was to have an audit of the very highest quality and he had some expectation that the audit firms would recognize that very aggressive price competition could be counterproductive.[39]

18. For many CFOs and, particularly, ACCs the level of fees was not a primary concern, even if fees were reduced as a consequence of a tender; cost was less important than service quality. The ACC of Company W negotiated a reduced audit fee, but had not set out to do so, his objective was to get the best audit, with the fee to be negotiated secondarily.[40] This view was typical of many.[41] Nick Land would favour leaving the negotiation of fees to the last stage of the tender process, which would

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[34] Case Study N, paragraph 36.
[35] Case Study Q, paragraph 5.
[36] Case Study R, paragraph 42.
[37] Case Study U, paragraph 28 ('The ACC would be worried if the fee was reduced too much, and it would be his responsibility to push back when such a situation arose').
[38] Case Study L, paragraph 4.
[39] Meeting with Nick Land, paragraph 9.
[40] Case Study W, paragraph 34.
[41] See, for example: Case Study M, paragraph 26; Case Study N, paragraphs 2, 10 & 29; Case Study Q, paragraph 5; and Case Study R, paragraph 5.

mean that the primary focus of the competition would be on the quality of the offering and the audit service, rather than on fees and he believed that some recent tenders had adopted that approach.[42]

Benchmarking audit standards and price

19. Almost all the case-study companies, to varying degrees saw value in using tenders as benchmarking exercises. In the view of the ACC of Company K, a tender provided an opportunity for other auditors to put their best foot forward or encourage the incumbent to up its game.[43] On taking up the post at Company N, which had never held a tender for an audit engagement, the ACC questioned how a company could know what the market had to offer without a tender.[44] The GFD of Company R thought the primary benefit of holding a tender was getting a better idea of the actual ability of the Big 4 audit firms rather than their perceived ability. Although the company had interactions with other audit firms around the world, a tender gave a more granular understanding of firms' capabilities.[45]

Inherent benefits of tendering

20. Holding a tender was therefore often seen as beneficial even if the incumbent audit firm was retained. Exemplifying this approach, an ACC of a financial services company had organized a 'partial tender', involving the dispatch of letters to three of the Big 4 firms as a means of 'sharpening up' the services of the incumbent firm; the threat of a full tender had succeeded in obtaining a more robust, independent approach by the incumbent and some reduction in fees.[46] Nick Land recounted that on one occasion he had retendered an engagement with just the incumbent firm and

[42] Meeting with Nick Land, paragraph 23.
[43] Case Study K, paragraphs 20 & 24. See also Company O, paragraph 21.
[44] Case Study N, paragraph 21. See also Company P, paragraph 1; Company Q, paragraph 2; Company S, paragraph 12.
[45] Case Study R, paragraph 3. See also Company V, paragraph 1; Company S, paragraph 12.
[46] See Case Study S, paragraph 32: the incumbent committed, among other improvements, to 'more robust and detailed audits, providing greater insights into how decisions were made and into the strengths of the company's controls, processes and systems and what aspects of the financial statements were driven by manual accounting estimates'.

it was striking how this had stimulated a radical look at the way the firm planned and undertook the audit.[47]

21. Company S had held a tender following a merger and one of the merged companies' incumbent firms was appointed. The FD said that if it had appointed one of the incumbent auditors as group auditors without a tender, the auditors would not have redeveloped the audit approach to consider the company in its own right, rather treating it as a spin-off from the former parent; further the tendering process had been hugely beneficial: fees came down, it got the appointed firm focused on what the business needed and forced the company to consider what it considered to be the most important facets of the audit service.[48]

Strategic benefits

22. A couple of interviewees had seen strategic advantages in organizing tenders before the new corporate governance requirements became more widely applied or other regulatory changes came into force. The ACC of Company N said that with many other tenders by different companies likely to be held, but with uncertainty over when and in what order, there was an advantage in being 'ahead of the game' so as to get the best terms and teams on offer.[49] The AC of Company W had decided that the timing of their audit tender was an opportune moment to hold a tender because of impending changes under IFRS and US listing requirements.[50]

[47] Meeting with Mr Nick Land, paragraph 5.
[48] Case Study S, paragraphs 11 & 12.
[49] Case Study N, paragraph 24.
[50] Case Study W, paragraph 1.

Other motives

23. The GFD of Company P said that, among the company's key objectives of going to tender was to take a look at dovetailing the external audit was the internal audit to avoid duplication of effort.[51]

Tendering: the process

Initiators

24. There was no dissent among CFOs about the principle that the AC held the ultimate responsibility, on behalf of the shareholders, of appointing a company's auditors.[52] The CFO of Company O said that discussions about the timing of the next tender were up to the ACC and that the CFO wanted to remove himself from the discussion of this issue.[53] In practice, it was not always the ACC who initiated the tender. The CFO had taken the lead in Companies R, T and U,[54] for example, although the AC had been brought into the process rapidly and the decision to tender was sometimes presented as a joint one (eg by Company P[55]).

25. None of the case studies noted pressure from company shareholders as a reason to institute a tender.

Invitations to bid

26. Some of those interviewed said that only the Big 4 were able to audit the business of specialized, complex or international companies. For example, the CFO of the asset management company N, said that the company had determined that only the Big 4 firms could handle the complexity and global reach of the company's activities; in the CFO's view, the smaller firms would not want to bid for the full audit but would be

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[51] Case Study P, paragraph 2.
[52] See, for example Case Study O, paragraphs 27 & 29.
[53] Case Study O, paragraph 3.
[54] Case Study R, paragraphs 2 & 28; Company T, paragraph 20; Company U, paragraph 3.
[55] Case Study P, paragraph 17.

considered for other non-audit service contracts.[56] The CFO of Company O said that 'the second-tier companies' could not take on the complex, international accounts of companies like company O.[57] The ACC of Company K, which had invited eight firms to bid but had received bids only the Big 4, said that none of the Mid Tier auditors had sufficient experience in the company's particular industry.[58] The CAO of Company W, an insurance and pensions provider, said the company did review the capabilities of the Mid-Tier firms and concluded that they did not have sufficient actuarial experience. Company W's ACC said that all big multinational companies were limited to the Big 4 because of the global resources required to audit such companies.[59] Nick Land saw 'little chance that second tier firms could develop to challenge the listed audit practices of the Big 4, without a massive global shake-up'.[60]

27. These companies identification of the Big 4 as the only realistic participant in tenders was reinforced in some cases by a tendency to invite firms to bid with which the Companies had had earlier relationships.[61] The ACC of Company P noted that he had had 'no concerns about audit failure because all of the Big 4 firms had done work for the Company so the new auditor was not starting from scratch'.[62] The GDF of Company T acknowledged that 'the bidders were selected because they had an existing relationship with the Company or had had a relationship with them in the past'.[63]

28. Moreover, in some cases companies had taken a strategic decision to limit bidders. The CFO of Company V said that the disruption to the company was limited by the fact that the tender process was a two-horse race and for this reason had not been

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[56] Case Study N, paragraph 5.
[57] Case Study O, paragraph 11. See also Case Study Q, paragraph 3.
[58] Case Study K, paragraphs 3 & 22; see also Company Q, paragraph 3; Company R, paragraph 28; Company S, paragraphs 3 & 4.
[59] Company W, paragraphs 4 & 35.
[60] Meeting with Nick Land, paragraph 30.
[61] We note that some case study companies also referred to using Mid Tier firms for NAS.
[62] Case Study P, paragraph 26.
[63] Case Study T, paragraph 5.

an overly burdensome process and this had been a deliberate strategy.[64] Its ACC said that Company U, in issuing invitations to bid to three firms, had had concerns about the amount of management time that would have to be spent on servicing and assessing four bids at a particularly inconvenient time for the company; however, in other circumstances, the number invited to tender might have been greater.[65]

The contest

29. The division of roles between the non-executive and executive arms during the conduct of a tender was much the same in all the case-study companies, although some ACCs became more directly involved in the processes than others. The project was in all cases managed by executive management and staff of the companies.

30. The CFOs of at least six companies thought that the opportunity cost to companies of tendering was manageable and calculable in advance. This view was largely based on recent experience of conducting a tender. Several challenged any notion that holding a tender was unduly disruptive of other executive activities:

(a) The CFO of Company K—which although a large company had only one main head office where the audit work was concentrated—said that the tender process had not been a major disruption for the company. He 'thought that the lack of tendering amongst other companies was down to laziness'.[66]

(b) The CFO of Company L thought that conducting a tender was not very resource intensive; a tender process would be likely to be run by the Group Financial Controller with input from the GFD and approved by the ACC; producing the required initial documentation for prospective audit firms would take a significant amount of the finance team's time for a few weeks.[67]

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[64] Case Study V, paragraph 6.
[65] Case Study U, paragraph 15.
[66] Case Study K, paragraph 9.
[67] Case Study L, paragraph 6.

(c) The GFD of Company P said that the tender process had not been disruptive for the finance team.[68] The ACC added that the amount of extra work required of him and the company during the tender was not sufficiently material to affect the decision to tender.[69]

(d) The GFD of Company R thought that the level of disruption caused by a tender depended on the number of meetings requested by the firms, although this was likely to be relatively minor. He considered that there was certainly an opportunity cost of the time spent running the tender, but that this would be borne through additional workloads of staff members engaged in and supporting the tender process.[70] The ACC at that company said that providing audit firms with access to individuals and data they needed took time and effort, but that this was relatively easy to cope with.[71]

(e) The FD of Company T said that the tender process did not cause significant disruption to the company.[72] The ACC also, in general, considered that the financial and opportunity costs in terms of management time were exaggerated and should not be used as an excuse not to tender. The costs could be minimized by a well-designed tender process.[73]

(f) The CFO of Company V said that the amount of time he had spent was 'non-trivial' but not enormous and was absorbed into day-to-day work loads. The CFO thought that the tender process was not a major burden on any one individual's time. He added that the disruption had been limited by the 'deliberate strategy' of holding a two-horse race.[74]

31. However, a few interviewees said that the tender process was excessively time consuming and that running the tender involved executives in considerable additional

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[68] Case Study P, paragraph 11.
[69] Case Study P, paragraph 19.
[70] Case Study R, paragraph 8.
[71] Case Study R paragraph 28.
[72] Case Study T, paragraph 7.
[73] Case Study T, paragraph 26.
[74] Case Study V, paragraph 6.

work at the cost of their normal duties. The ACC of Company O said that it was necessary to spend time to ensure bidders had the same knowledge of the company as the incumbent and the briefing of potential bidders was onerous.[75] The FD of Company S said that the tendering process had been very time-consuming and far more so than expected; he estimated that, over a six-week period, his company's tender occupied 20 per cent of his time, 50 per cent of the finance team's time and a significant amount of the time of other senior business heads.[76]

32. Some companies took steps to minimize this opportunity cost, for example by setting up data rooms,[77] although Company S took the view that a data room created too great a risk of the disclosure of confidential information.[78] Only one company reported having employed an external consultant to help run the process.[79] In terms of the time individual CFOs and their teams spent on a tender:

(a) The CFO of Company K estimated that he spent approximately three to four days of his time on the tender process, with the procurement team spending a similar amount of time and his Financial Controller a little more; there was virtually no effect on the wider Finance team during the tender.[80]

(b) The CFO of company N said that he spent three to four weeks over four to five months on the tender (but not at the expense of other work) and two individuals reporting to the CFO worked almost full-time on the tender, significantly displacing other work. (However, the tender coincided with other important changes within the company, and the resource cost would likely be lower in different circumstances.)[81]

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[75] Case Study O, paragraph 24.
[76] Case Study S, paragraph 5. For another instance of high estimated opportunity cost, see Case Study N, paragraph 14; its tender coincided with other important, resource-intensive changes within the company.
[77] Companies N and W did so.
[78] Case Study S, paragraph 16.
[79] Case Study W, paragraphs, 2, 6 & 26.
[80] Case Study K, paragraph 8.
[81] Case Study N, paragraph 14.

(c) The GFD of Company P estimated that the process had required two weeks of his time, and one week of the CEO's time. He noted that this time was spread over three months and was absorbed into the individuals' existing workloads.[82]

(d) The FD of Company S estimated that, over a six-week period, his company's tender occupied 20 per cent of his time, 50 per cent of the finance team's time and a significant amount of the time of other senior business heads.[83]

33. According to several ACCs, a major part of their role in the tender process was to ensure that the process was thorough.[84] The ACC (at Company N), for example played an important role in assuring prospective bidders that the tender process was going to be fair and open.[85] The ACC would therefore typically be involved in the design of the tender process and the establishment of the evaluation criteria, as well in interviewing and helping select the bidding firms.

34. The ACC of Company U said that he personally spent probably three days on the bids—three hours briefing each bidding team, time spent in discussions with the CFO and reviewing the written presentations and a day attending the oral presentations and subsequent internal discussions.[86] The ACC of Company S reckoned he had spent about 30 hours, additional to normal activities, over about three months.[87] The ACC of Company P thought his time commitment had been about 15 hours,[88] while the ACC of Company N reckoned to have devoted about ten days, in addition to normal activities, to work connected with the company's tender.[89] As Nick Land commented, the amount of time an ACC spent on AC-related work (in his case some

[82] Case Study P, paragraph 11.
[83] Case Study S, paragraph 5.
[84] See, for example, Company R, paragraph 31.
[85] Case Study N, paragraphs 25 & 26.
[86] Case Study U, paragraph 16.
[87] Case Study S. paragraph 16.
[88] Case Study P, paragraph 19.
[89] Case Study N, paragraph 27.

15 days or part-days) would vary depending on the size and complexity of the company issues involved and would sometimes have to be flexed.[90]

35. The organization of the process was fairly standard among the case-study companies, although there were variations in the ways that the companies involved their overseas entities in it (see paragraph 40 below). Most set up dedicated teams to conduct the tender. (One company (K), however, conducted its tender using its internal procurement function, 'which helped apply structure to the process and made sure the company adhered to the relevant rules'.[91]) The arrangements followed by Company N[92] contained most of the typical elements:

(a) The tender process gave the bidding firms extensive access to non-executive directors and financial and non-financial management worldwide. In each interaction, the firms were awarded scores and given rankings. In scoring the firms, the company applied four main criteria: *(a)* oversight and governance (eg safeguards for independence, communication); *(b)* planning and delivery; *(c)* people and succession planning (eg their judgement, technical abilities); and *(d)* value. The meetings lasted about an hour to an hour and a half, with the firms having to provide agendas and CVs in advance, and involved at least 30 meetings with the company's staff. (Company N set up data rooms to help the companies and minimize business disruption.)

(b) The firms were then asked for written statements, which were read by all AC members, the CFO and other relevant management executives and scored. A number of questions to be put to the candidate firms during their presentations were identified by the company, to either clarify or challenge aspects of the written proposal.

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[90] Meeting with Nick Land, paragraph 20.
[91] Case Study K, paragraph 2.
[92] Case Study N, paragraphs 6–9.

(c) Finally, the firms made oral presentations to the ACC, with executive management (including CFO, Group Financial Controller and General Counsel) and the Chairman present.

36. On the evidence of the case studies, the period the selection process took place over ranged between about eight/ten weeks and six months.[93] The variations in time taken are likely to have reflected the relative complexities of a company's non-audit engagements and international operations (see below, paragraphs 41 and 62).

Selecting an auditor

37. Little difference was seen among the Big 4 firms in terms of technical, 'pure audit' competence. For example, the GFD of company P[94] and the ACC of Company N[95] said that auditing was almost a commodity product; the ACC of Company R said that, by using a Big 4 firm the company would get the same technical quality;[96] and the GFD of Company T said that 'switching auditor had not affected audit quality because the Big 4 firms provided a high quality audit'.[97]

38. Against this background, certain factors that might help determine the choice of auditor emerged from the case studies. These are described in the following paragraphs.

Sectoral specialization

39. Companies valued the sectoral specializations of firms. Company V, for example, did not consider inviting one of the Big 4 firms to tender because it did not have the

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[93] Eight/ten weeks Case Study W, paragraphs 7 & 20; three months (Case Study P, paragraphs 4 & 11; Case Study V, paragraph 2; and Case Study S, paragraph 26); six months (Case Study T, paragraph 6).
[94] Case Study P, paragraph 9.
[95] Case Study N, paragraph 33.
[96] Case Study R, paragraph 35.
[97] Case Study T, paragraph 16.

relevant sector experience.[98] Company L's ACC said that whilst the Big 4 all had global capacity they were not equally skilled with regard to digital and media developments.[99] Relevant experience was considered particularly helpful during the induction of a new auditor; Company K's ACC said that there had been no dip in the quality of the audit in the first year and the newly appointed auditor hit the ground running because the partner had experience of the company's industry.[100] The main criteria applied by Company S in choosing an auditor were, in addition to capabilities and judgement, was having an understanding of the business.[101] In the case of some multinational companies, the sectoral experience was sometimes related to specific markets in which the companies operated. One company (Company U) considered that one of the bidders 'was not considered strong in the geographical areas in which the Company had set up new operations'.[102]

Worldwide delivery

40. A firm's international capability was a crucial factor for the choice of auditor for companies with complex global operations. In this regard, Company O's CFO said that:

> in assessing the bidding firms, must be confident that they had fully understood what they were taking on. Otherwise the fee or the scope of their work could be understated. This applied particularly to the firms' ability to audit the overseas subsidiaries. While the quality of its overseas partners might be patchy, the firm needed to convince the Company that it can drive quality assurance from the centre. If the Company were to be dissatisfied with the work of an overseas partner it would ask for that partner to be rotated.

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[98] Case Study V, paragraph 3; see also Company Q, paragraph 4.
[99] Case Study L, paragraph 19.
[100] Case Study K, paragraph 33.
[101] Case Study S, paragraph 9. This knowledge of the business included understanding the entity and the industry.
[102] Case Study U, paragraph 12. See also Company P, paragraph 10.

41. The ACC of that company said:

> The key ingredient of success for an auditor of a multinational company as getting the local delivery right. Much of an audit firm's work was performed abroad and the strength of the local offices was a major consideration. In reaching a decision on the appointment of an audit firm, an assessment of the bidder's capabilities was therefore extremely important.[103]

42. The GFO of Company U emphasized that:

> a key consideration was the ability of the audit firm to audit all of the subsidiary companies worldwide. Appointing different auditors for the different geographical segments of the business was not seriously considered; a single firm would be more efficient managerially, would drive down costs, would (he supposed) be able to take assurance more readily from other member firms in the network, would find it easy to co-mingle audit teams and would be able to ensure compliance.[104]

43. An important part of the selection process was therefore the input from a company's overseas operations. Company O, for example, made a point of writing to the financial officers in its overseas operations for assessment of local representatives of audit firms.[105] Company W arranged extensive meetings between regional CFOs and local audit partners around the world, under strictly controlled conditions. Feedback from regional CFOs was evaluated centrally and presented at a meeting with the AC.[106] In the case of Company U, the bidding firms made presentations to the local

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[103] Case Study O, paragraphs 5 & 26. See also Company R, paragraph 13.
[104] Case Study U, paragraph 2.
[105] Case Study O, paragraph 26.
[106] Case Study W, paragraph 5.

finance teams in the overseas locations and the feedback from the teams was taken in account by the selection panel.[107]

Relationship with the AEP

44. Relationships with the proposed AEP and the wider staff team can also be important in the choice. Both the CFO and the ACC of Company N identified the prospective AEP to be a key factor in an audit engagement, particularly the AEP's readiness to engage in dialogue with the AC and the degree of scepticism applied in his or her approach. The audit firm from which the AEP came was of lesser concern and it was therefore important for a company to get to know the audit team during a tender process.[108] Nick Land commented that 'from the ACC's viewpoint, his most important professional associate was not the CFO but the lead audit partner'.[109]

45. Similar comments were made by the CFO of Company M who said the interaction with staff was often an important factor in the choice of auditor;[110] the ACC of Company M said that the key relationship was not with the firm but with individuals within that firm[111] and the ACC of Company U who said a key criterion for the selection was the ability of the AEP.[112]

46. In similar vein, Company W said that one of the reasons it tendered its audit was because it did not feel that the new partner being put forward [to follow an imminent partner rotation] was the best person for the job and that better partners may be available at other firms.[113]

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[107] Case Study U, paragraph 17.
[108] Case Study N, paragraphs 10, 33 & 40. The ACC said that the 'quality of a prospective AEP can be assessed during interviews as part of the tender process, on the basis not only of what was said but what was not said, body language and so forth'. For similar views see also Case Study P, paragraph 3.
[109] Meeting with Nick Land, paragraph 21.
[110] Case Study M, paragraph 8.
[111] Case Study M, paragraph 27.
[112] Case Study U, paragraph 18.
[113] Case Study W, paragraph 19.

Other factors

47. Company P appointed its auditor because its proposal focused on delivering a high quality audit and the auditor had stated that it would not look to offer additional services.[114] The extent of their non-audit work was more likely to be a factor for the audit firms in considering whether or not to pursue a bid. The case studies showed that some firms were not deterred from bidding for an audit even though they were conducting non-audit service projects worth more than the audit fee. However, in at least one case, a firm was deterred from bidding for an audit engagement because it preferred to maintain its ongoing consulting work for the company.[115]

Incumbency advantage?

48. Views were mixed on whether or not incumbency was an advantage to a firm in the current situation. Company K's ACC said that an incumbent would generally be at an advantage if it was a good performer.[116] The ACC of Company S said that choosing an incumbent was always perceived as less risky, and the risk of change had led to the selection of the incumbent and that the challenger would have had to be far ahead in terms of competence and skills to have overcome this factor.[117] The ACC of Company N had taken pains to assure all bidders that the inclusion of the incumbent would not lead to any lack of fairness and openness; otherwise the ACC felt that the inclusion of the incumbent in the invitation to tender might have reduced the efforts of other bidders. However, on the other hand, according to the ACC of Company R, a company had to consider, in appointing an auditor after a tender, how the market and investors would react if the incumbent was reappointed given their length of tenure and the appointment decision would require careful explanation if the Company

[114] Case Study P, paragraph 10; see also Case Study T, paragraph 33.
[115] This happened when Case Study W opened its tender, see Case Study W, paragraphs 4 & 22.
[116] Case Study K, paragraph 31.
[117] Case Study S, paragraphs 27 & 31. See also Case Study T, paragraph 31: 'if forced to choose, companies would generally rather have an incumbent in place for a period of time than regularly go through the process of inducting a new firm'.

decided to stay with the incumbent.[118] The GFD of Company P went further, saying that the company was less likely to appoint the incumbent auditor given they had gone out to tender and that the incumbents' odds of success were lower than others because of this.[119]

Views on mandatory tendering

49. Most interviewees recognized that the FRC provisions for ten-year tendering, on a 'comply or explain' basis were acceptable as a healthy discipline, allowing a company to cross-check the provision of audit services.[120] Company O's ACC considered there were benefits to be gained from a cycle for tendering and ten years seemed reasonable.[121] The CFO of Company V did not consider that mandatory tendering was essentially different from the FRC's 'comply or explain' tendering requirements stating that 'comply or explain' leads to compliance in the vast majority of cases.[122] Some others agreed that companies would explain for a year or so but would then comply, although there was also a view, such as expressed by the GFO of Company N, that while clearly an implicit encouragement to compliance, there was likely in practice to be a range of responses from companies,[123] and at least one ACC (of Company R, which was in the process of organizing a tender) thought that 'if a switch turned out to be a lengthy and difficult process, the company might wish to explain for a while in future.[124] Many others also opposed making tendering mandatory: stating it would add to bureaucracy[125] or that it was a sledgehammer to crack a nut and change for change's sake;[126] and that an AC had the power to order

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[118] Case Study R, paragraph 34: 'Ultimately, in deciding whether to switch there were essentially three questions that needed to be answered. The first was which firm would provide the best service and thus the greatest benefit to the Company and its shareholders; the second was what the cost, (financial and operational), of switching would be; and the third was how would the market and investors react if the incumbent was reappointed given their length of tenure.'
[119] Case Study P, paragraph 8.
[120] Case Study G, paragraph 12.
[121] Case Study O, paragraph 18. See also Case Study P, paragraphs 21 & 28.
[122] Case Study V, paragraph 17. See also Case Study S, paragraph 36; Case Study W, paragraph 36 (arguing for allowing more time for the FRC's requirements to take effect to see if they had any impact).
[123] Case Study N, paragraph 17.
[124] Case Study R, paragraph 36.
[125] Case Study M, paragraph 11.
[126] Case Study U, paragraph 11.

a tender without mandatory underpinning; it took such decisions after calculating the costs and risks involved.[127]

50. Some interviewees were prepared to see shorter times between tenders. The ACC of Company K would recommend going to tender every five to ten years.[128] The ACC of Company Q could see some benefit in a tender cycle of between seven and nine years, but this should not be mandatory as comply or explain was the basis of good governance.[129]

51. A few, such as the ACC of Company T had no issue with the proposal for mandatory tendering and thought a six-year period between tenders was reasonable.[130] The ACC of Company M would not oppose mandatory tendering; the key issue would be their frequency.[131]

52. Regardless of whether or not tendering was mandatory, the interviewees would like the precise timing of a tender to be flexible because the tender date might not fall at a convenient time for the company.[132] The CFO of Company N said that the timing of tenders should be left to the discretion of the companies.[133] The ACC of Company L stated that if no discretion is allowed having mandatory tendering could affect how a company planned its acquisitions or changed its functional and reporting systems.[134]

53. Several interviewees suggested that a tender could be linked to the rotation of the AEP. While not objecting to the mandatory rotation of AEPs, some ACCs[135]

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[127] Case Study S, paragraph 36.
[128] Case Study K, paragraph 26.
[129] Case Study Q, paragraph 12.
[130] Case Study T, paragraph 27.
[131] Case Study M, paragraph 29(a).
[132] See, for example, Case Study K, paragraph 25.
[133] Case Study N, paragraph 3.
[134] Case Study L, paragraph 28.
[135] Case Study G, paragraph 14; Case Study U, paragraph 25. The ACC of Case Study Q, however, said that the rotation of AEPs was 'double-edged. The best partners tended to focus on winning new work. When an AEP moved on, the quality of the audit tended to decline'.

advocated reverting from the current five-year rotation, prescribed by the FRC, to a seven-year cycle. The GFD of Company P suggested a link to the tenure period of non-executive directors: their term of office was six to nine years and the GFD would not want to go to tender more frequently than a six-year period because this would send a negative signal to shareholders about the company's relationship with its auditor.[136]

54. Some interviewees considered that mandatory tendering, and the consequently greater frequency of tenders, would lead to fewer firms being available to compete for the engagements. The ACC of Company G feared that one problem that could result from mandatory tendering would be that, with several firms going for several tenders around the same time, fewer well-qualified firms and teams would be available for new engagements.[137] Similarly, the ACC of Company O considered that more frequent tendering could discourage some of the Big 4 from bidding for particular tenders.[138]

55. The ACC of Company N did not perceive there to be significant efficiencies from more frequent tendering, given the extensive range of interviews needed to be held to allow firms to tailor their tenders. There would potentially be an increase in the level of ongoing monitoring or shadowing of the company by firms, particularly as a tender was anticipated to be held, to improve firms' understanding of the company's business, but overall the ACC did not think this would reduce costs. The ACC of Company R, on the other hand, conceded that more frequent tendering might lead to a more efficient process over time, but could not be sure.[139] The ACC of Company O

[136] Case Study P, paragraph 7.
[137] Case Study G, paragraph 13.
[138] Case Study O, paragraph 20. The ACC noted that mandating more frequent tendering (and switching) could 'reduce the numbers among the Big 4 firms ready to bid for particular tenders; if they consider that they will end up winning only a few audit tenders, they might weigh up the cost of losing the non-audit services they are providing to a company against the prospects of being awarded the audit and decide not to bid for the audit tender, reducing the Big 4 firm pool in those cases to one or two firms'.
[139] Case Study N, paragraph 39.

thought the costs to audit firms arising from frequent tendering would be passed on to the audit firms' existing clients.[140]

56. There was also a danger that greater frequency would lead to tenders become ritualistic only. The ACC of Company O said that if tenders were too frequent, there would be greater inclination to reappoint the same firm for another short cycle; the cycle needed to be sufficiently long that it was more likely to lead to a change in auditor.[141] The FD of Company S said that tendering should not be conducted in a 'box-ticking' fashion.[142] The ACC of Company N gave the fullest account of this risk:

> The ACC considered that a remedy of mandatory tendering, especially in combination with mandatory rotation of audit firms, represented a large risk. In the ACC's view, the more frequent the tender the less the potential 'prize' to the audit firm and the higher the cost and risk relative to the perceived benefit for both company and audit firm. As a means of reducing these costs there was a risk that, the running of a tender could become purely ritualistic, with no change in auditor at the end of the process. The combination of mandatory tendering with mandatory rotation every second tender, say, could lead to a situation in which only a ritual tender was held at the intervening period.[143]

The challenges of switching

57. In bringing a fresh pair of eyes a new auditor could provide insights the former auditors may have overlooked. According to the ACC of Company M, the benefits of switching were in terms of value added—bringing to the company a fresh, independent perspective, derived from the firm's external experience and knowledge. A new auditor brought a fresh assessment, derived from asking basic questions,

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[140] Case Study O, paragraph 24.
[141] Case Study O, paragraph 27.
[142] Case Study S, paragraph 20.
[143] Case Study N, paragraph 37.

particularly related to the company's control systems.[144] The GFD of Company T, confirmed that he had gained additional insights as a result of switching auditor.[145]

58. As the GFD of Company U pointed out, casting a fresh pair of eyes on a company's accounts carried a degree of risk that, in going through the accounts, the new auditor might disagree with its predecessor's assessments. However, the GFD considered that 'this risk could be seen as a benefit in terms of getting a 'nuts and bolts' re-examination without making a restatement as a result'.[146]

59. On the other hand, there was a general recognition that companies had to weigh the benefits of obtaining a new auditor's 'fresh pair of eyes' on the company's business against the risk that the incoming firm would not know as much about a company as its predecessor, would be less prone to probing questioning and could fail to spot an important auditing issue. This view was expressed by Company O's CFO who said that the value of having the fresh pair of eyes of new auditors was offset by the auditors' lack of understanding and lack of experience of what they were auditing. In the CFO's view, this lack of understanding meant that the new team was likely to miss something; and the lack of experience handicapped them when it came to making the many judgements in auditing. Sector experience helped to some extent with this but the first year of a new audit team's incumbency was difficult.[147] Others agreed that it took some time for a new auditor to get up to speed and that some temporary deterioration in quality was likely during the first year; it took some time for a new auditor to reach full technical proficiency.[148] This placed an important

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[144] Case Study M, paragraph 23.
[145] Case Study T, paragraph 16; see also Case Study O, paragraph 22.
[146] Case Study U, paragraph 9.
[147] Case Study O, paragraph 6. See also, for example, Company G, paragraph 9; Company N, paragraph 32; Company W, paragraph 12.
[148] Case Study T, paragraph 32. See also, for example, Company N, paragraph 15.

responsibility on the ACC, said the ACC of Company U, to make sure that all issues that should come up [in the first year of] the audit did so.[149]

60. The induction of a new auditor therefore could put strain on company and AC resources (although the main costs of switching would be likely to fall on the audit firm). Estimates of the impact varied widely. The GFD of Company P, which had been conducting a half-year interim audit review when the new auditors arrived, said that the audit firm spent perhaps six times as much time as normal on the review and staff spent more time that usual with the auditor—perhaps an extra 60 man-days at a cost of £50,000 to £60,000.[150] The CFO of Company K, on the other hand, had found that the transition process was less intensive than he had expected,[151] and the GFD of Company T 'estimated that any additional hours that were necessary to spend with the new auditor in the first year of its appointment were not too significant'.[152]

61. There was a similar diversity in the estimates of the additional time an ACC would need to devote to helping the induction of a new auditor. The ACC of Company T said that he 'had to spend twice as much time on Company T's business when the new auditors were first appointed than he spent during a normal year' (he regarded this 'as time well spent').[153] The ACC of Company W said that he spent only a few additional hours on top of the 50 to 60 days he devoted to his ACC work and that the change of auditor did not have a significant time implication for him or for the rest of the AC.[154]

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[149] Case Study U, paragraph 21.
[150] Case Study P, paragraph 12.
[151] Company K, paragraph 10.
[152] Case Study T, paragraph 12—the GFD continued: 'It was common that new members were added to an incumbent audit team, year on year and, to this extent, it was necessary to educate their new members about the business of the Company in any event. Accordingly, while switching to a new auditor could add a number of additional hours in the first year, that number was not much more than the usual process.'
[153] Case Study T, paragraph 31.
[154] Case Study W, paragraph 31. See also Company L, paragraph 24.

62. Some interviewees argued that switching costs could be reduced by careful transition planning. Companies N, U and W, in considering prospective auditors, asked the firms to produce proposals to do so; according to the ACC of Company U, the prospective auditor's transition plan would therefore be a key factor in the decision whether or not to switch.[155] The ACC of Company G stated that a long, intense tendering process could be seen as part of the induction process.[156] Nick Land said that, in his previous experience as an AEP, companies found that switching auditor was less disruptive than expected and that the transition to a new audit firm could be relatively painless. He disagreed that, if well planned, switching necessarily gave rise to significant costs.[157]

63. The ACC of Company Q drew attention to the need to deal with an outgoing firm during the switching process.[158] The GFD of Company R from past experience believed that the new auditor shadowing the previous auditor did not work. For other companies, this did not seem to have been a problem during a switch of auditors (having the new auditor shadow the incumbent seemed to have worked well in the cases of Companies M and W.[159]

Independence checks

64. The real challenge for global companies, particularly in the financial sector, was to check on the independence of a selected new auditor. A major challenge for Company Q—and inherent in all major switching operations—was the reorganization of the provision of NAS and it was a long process to analyse the range and nature of all Company Q's NAS. It was further complicated because some NAS could not be

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[155] Case Study N, paragraph 34; Case Study W, paragraph 19; Case Study U, paragraph 23.
[156] Case Study G, paragraph 11.
[157] Nick Land, paragraph 6. Commenting that some audit firms were skilled at minimizing switching costs, Mr Land thought that they would continue to improve in this area as the instances of tendering increased and audit firm would develop more streamlined tendering processes.
[158] Case Study Q, paragraph 9.
[159] Case Study M, paragraph 4; Case Study W, paragraph 10.

changed, for example, those involving ongoing litigation or government negotiations. In all, about two-thirds of NAS provided by the auditor had to be retendered.[160]

Outcomes of switching

65. Generally, companies that had switched auditors had not seen any marked improvement of the quality of the audits, but several commented on the value added benefits of switching:

(a) Company K had seen a more accessible reporting style from the new auditor;[161]

(b) Companies T had gained additional insights as a result of switching auditor;[162]

(c) Company V noted that the new auditor had changed the audit approach and emphasis and this was what the company was looking for;[163]

(d) Company U was receiving a significantly more challenging audit;[164] and

(e) Company W had received a fresh set of perspectives on the business.[165]

Mandatory switching

66. There was little support for mandatory switching of audit firms. It would lead to less choice, since the incumbent would have to be excluded.[166] The FD of Company S said that mandatory switching would have left Company S with the choice of only one firm (if it could not have appointed its incumbent).[167] The ACC of Company W said that mandatory rotation would have reduced his company's choice to two firms.[168]

67. However, at least two interviewees considered that mandatory switching would be acceptable. The CFO of Company M said that it would be acceptable if a reasonable

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[160] Case Study Q, paragraph 7.
[161] Case Study K, paragraphs 13 & 34.
[162] Case Study T, paragraph 16.
[163] Case Study V, paragraph 14.
[164] Case Study U, paragraph 24.
[165] Case Study W, paragraphs 14 & 34.
[166] Case Study N, paragraphs 16 & 38; Case Study Q, paragraph 14.
[167] Case Study S, paragraph 19.
[168] Case Study W, paragraph 23.

period of time is allowed (say, ten years) and the ACC of Company M agreed stating the key issue would be the frequency of mandatory tendering and switching.[169]

[169] Case Study M, paragraphs 11 & 29(a).

Mandatory tendering

FTSE 350 companies

1. Aggreko said that the audit should be tendered after a period of ten years for reasons of audit quality and cost evaluation, a sensible period as it allowed for two audit partner rotations. Given the introduction of the FRC provision, the growing awareness of Boards and ACs of retendering support and the early positive signs of progress, it seemed unnecessary to change what the FRC has introduced. Aggreko also said that audit tender can be an expensive and disruptive process. Aggreko considered that an open-book process would not significantly reduce company or auditor costs and was concerned that confidential information would be more widely available.[1]

2. Barclays supported the FRC's ten-year comply or explain regime. It considered that it was likely to increase transparency and to enable shareholders to make an informed decision whether to tender. It considered that the option of whether to tender was a cost-benefit decision for the AC and shareholders and should not be mandatory. Tenders are said to involve significant disruption to the business activities of multinational companies. Barclays estimated that a single tender process would involve in excess of 200 staff and 1,000 man days over two years.[2]

3. Barclays also said that the tendering was costly for audit firms and that tendering for statutory rather than competitive reasons would be likely to result in firms passing on the costs to tendering clients either in the form of higher fee rates or as a billable

[1] Aggreko response to the Remedies Notice.
[2] Barclays response to the Remedies Notice.

service. Barclays were also concerned that the process could be a distraction for the incumbent audit firm.[3]

4. Barclays considered that mandatory tendering would not be an effective method of ensuring non-Big-4 firms were considered by FTSE 350 companies as most mid-sized firms would not have the experience, capacity or global footprint required by multinationals.[4]

5. Berkeley Group Holdings Plc supported the FRC's comply or explain approach as a measure to encourage transparency whilst protecting the AC's ability to decide what was right for the shareholders at any point in time. Berkeley did not support an open-book process. It considered that there was a sensible, pragmatic accepted approach to tendering audits which provided good access to the business and key management for tendering firms. It did not believe it necessary to share confidential information during the tendering process for firms to understand the risks, scope and best approach to undertaking the audit.[5]

6. BT Group said that it supported of the FRC provisions. It did not see a need to go beyond these. A tender process would need to be managed around other commitments, projects and commercial focus to time the tender process at a least disruptive time. A five- to seven-year cycle might not allow for the necessary flexibility.[6]

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[3] Barclays response to the Remedies Notice.
[4] Barclays response to the Remedies Notice.
[5] Berkeley Group Holdings Plc response to the Remedies Notice.
[6] BT Group response to Remedies Notice.

7. GlaxoSmithKline said that the FRC provisions should be allowed time to take effect before introducing further changes.[7]

8. RBS said that it supported the new FRC provisions. Directors would be encouraged to explain to shareholders the rationale for the continuing appointment of a particular auditor at suitable intervals. RBS opposed an 'open-book' process as its auditor's working papers will contain information relating to the bank's clients and will be covered by the normal client/auditor confidentiality agreements.[8]

9. Rexam plc did not support open-book disclosures to tendering parties as it believed this would compromise confidentiality and could also serve to reduce innovation in the audit profession.[9]

10. SABMiller Plc considered that the new FRC provisions should be allowed time to take effect before introducing any further changes and that it was very important to retain the comply or explain basis as there could always be some intervening event that made it inadvisable to tender the audit at the end of the ten-year period, such as, for example, when there was a new CFO, a new chairman of the audit committee or if a company had recently been involved in any major corporate activity. It did not understand how tendering the audit every ten years necessarily increased the likelihood of more Mid Tier firms being appointed auditors to FTSE 100 or FTSE 350 companies, if they did not have the international reach and resources required both during the tendering process and immediately after appointment.[10]

11. [✂] said that it supported the new FRC provisions which were said to balance the need to safeguarding audit quality and effectiveness with pragmatism. It was

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[7] GlaxoSmithKline response to the Remedies Notice.
[8] RBS response to the Remedies Notice.
[9] Rexam plc response to the Remedies Notice.
[10] SABMiller plc response to the Remedies Notice.

concerned that an open-book process would give a number of firms access to highly confidential and sensitive information.

12. Segro Plc said that the case for reform was overstated, that mandatory tendering and rotation of audit firms was not the correct way forward and would not necessarily serve to reduce concentration in the audit market. Additionally, auditor appointment should be maintained at the discretion of shareholders and not become something that was imposed on them.[11]

13. Smiths Group Plc said that mandatory tendering every five or seven years was not necessary or proportionate. It considered that the new FRC provisions should be given time to prove their effectiveness and that the remedy would impose significant additional costs, risk and disruption from tendering. It was concerned that an open-book approach would enhance the risk of exposure of commercially confidential data and processes and impose additional administrative costs on the company.[12]

14. Smith & Nephew plc considered that the recent FRC provisions should be allowed time to take effect before introducing any further changes. Smith & Nephew plc also said that whilst recognizing the need to tender within the next few years, it was mindful of the disruption likely to be caused and the significant management time required to carry out this process effectively. This was something it would wish to address immediately following the very recent appointment of the CFO.[13]

15. Tate & Lyle supported the FRC's provisions.[14]

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[11] Segro plc response to the Remedies Notice.
[12] Smiths Group plc response to the Remedies Notice.
[13] Smith & Nephew plc response to the Remedies Notice.
[14] Tate & Lyle response to the Remedies Notice.

16. KPMG said that using the Global Audit Committee survey, conducted every year through KPMG's Audit Committee Institute, it sought to understand ACs' views on the impact of mandatory tendering. A majority of respondents (in the UK or on a global basis) in the latest survey noted that they did not view mandatory tendering as a way to improve audit quality (Global Audit Committee Institute Survey, 2013). Any reduction, or risk of a reduction, in tender or audit quality as a result of any remedy option is a significant cost, and we discuss further aspects of the impact on this remedy on audit quality below (in relation to innovation and investor confidence). The CC must take this cost into account in forming a view on the effectiveness and proportionality of the remedies it considers.[15]

Audit firms

Big 4 firms

17. The Big 4 firms did not support a remedy that would require companies to tender the audit engagement more frequently than required by the new FRC regime and supported a comply or explain regime. They argued that: the new FRC regime could be expected to result in regular tendering of FTSE 350 audit engagements; more frequent tendering was unnecessary to achieve the CC's objective and could be damaging to the competitiveness of tenders and the negotiating position of companies between tenders; and mandatory tendering every five or seven years would be disproportionate given that there would be substantial costs for firms and companies associated with tendering.

[15] KPMG response to the Remedies Notice, paragraph 3.2.7.4.

Appropriate time frame

18. The Big 4 firms argued that tendering of audit engagements would become a regular feature of the market under the new FRC regime; and that this regime should be given an opportunity to work before being dismissed as inadequate by the CC.[16]

19. The Big 4 firms said that the new regime was already having an impact on the frequency of tendering. ACs were said to have referred to this in over 20 FTSE 350 companies' annual reports for 2012. Firms said that many other clients had said they were considering going to tender in the near future. There were said to have been five completed audit tender processes by companies in the FTSE 350 since September 2012—three of which had taken place within the FTSE 100. These included Royal Sun Alliance Insurance Plc (won by KPMG from Deloitte), Schroders Plc (won by KPMG from PwC) and ITV Plc (retained by KPMG). In addition, a number of companies were said to have signalled their intention to initiate a tender process. HSBC Plc, Compass Group Plc, Domino Printing Sciences Plc, Foreign Colonial Investment Trust Plc and Ladbrokes Plc had all recently stated that they would tender their audits within the next three years. KPMG expected the number of companies signalling their intentions to tender their audits, or providing detailed considerations of their decision to reinstate their incumbent audit firm in the short term to increase dramatically as the full population of companies' first annual reports subsequent to the publication of the UKCGC becomes available.[17]

Mandatory v comply or explain

20. The Big 4 firms supported a comply or explain regime. They said that requiring tenders to occur at designated times (or requiring tendering at intervals that did not give ACs sufficient flexibility on the timing of a tender) could force companies to incur

[16] See the following: PwC response to the Remedies Notice, paragraph 3.12; EY response to the Remedies Notice, Annex 2, paragraph 2.2.
[17] See the following: PwC response to the Remedies Notice, paragraph 3.13; Deloitte response to the Remedies Notice, paragraph 3.6; KPMG response to the Remedies Notice, paragraph 3.1.4.

the costs and distraction of a tender at a time when it would be in shareholders' better interests for the company to be focused on other important events. For example, where a company was facing a financial or reputational crisis, or had just acquired a major new business, or where the ACC or FD had just left the company. However, in these circumstances, it would be expected to tender in the following year.[18]

21. The Big 4 firms expected a high level of compliance. Deloitte said that comply or explain principle was a central feature of the UK's corporate governance landscape and cited GT evidence that 96 per cent of companies tended to comply rather than explain. Deloitte considered that a decision by an AC not to tender in a given year would not be taken lightly, given the pressure to comply with expectations on good practice, and would require a full explanation to be given to shareholders.[19]

Impact on competition

Impact on the competitiveness and effectiveness of tenders

22. Deloitte said that if, as the CC envisaged, more frequent tendering would lead to a reduction in the intensity and hence the cost of the process there would be a risk to shareholders that the firm appointed would not be best placed to offer optimal levels of quality and value.[20]

23. PwC said that 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

[18] PwC response to the Remedies Notice, paragraph 3.33; EY response to the Remedies Notice, Annex 2, paragraph 2.9; KPMG paragraph 3.2.1.2.
[19] Deloitte response to the Remedies Notice, paragraphs 3.17–3.19.
[20] Deloitte response to the Remedies Notice, paragraph 3.22.

years ago and has therefore incurred the costs of educating that auditor on the business in the relatively recent past).[21]

24. Similarly, KPMG said that currently tenders often occurred after negotiations between incumbent audit firms and companies that had not resulted in a satisfactory outcome, and that in these circumstances the incumbent had a lower chance of winning the tender than (at least some of) its rivals. Under mandatory tendering, this would no longer be the case which may reduce the incentive for rival audit firms to participate in tenders if the incumbent audit firm was seen to have an advantage (as it will not have to incur the costs of 'getting up to speed' and the company will not have to bear similar costs of transition). KPMG said that this concern was less likely to arise with a comply or explain provision, since that allowed companies to retain their audit firm without tendering if they had no intention to change because they believed the incumbent provided the best offering and explain that decision.[22]

25. KPMG also said that if the number of tendering opportunities increased above current levels, audit firms might be less willing and able to devote the same level of resources to each individual tender opportunity or might be less willing to bid on all tender opportunities, and that this would be likely to have a material impact on the quality of submitted proposals, and therefore their information value for companies. Similarly, any reduction in the resources devoted to tendering by companies would be likely to undermine companies' incentives to ensure a high quality tender process. Alternatively, audit firms might be less inclined to participate in all tender opportunities that arise.[23]

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[21] PwC response to the Remedies Notice, paragraph 3.23.
[22] KPMG response to the Remedies Notice, paragraph 3.2.6.1.
[23] KPMG response to the Remedies Notice, paragraphs 3.2.6.4 & 3.2.6.5.

26. EY said that more frequent tendering might be expected to result in audit firms deciding not to respond to invitations to bid, or submitting less detailed bids, which would compromise the effectiveness of tendering as a means for companies to assess the relative abilities of audit firms. In particular, EY said that audit firms would be unable to devote the same effort and resources to responding to an average of 70 tenders a year as they would in responding to 35 tenders. As a result audit firms might: become more selective when deciding whether to submit a bid in order to focus resources more effectively which would reduce choice; or submit less detailed bids which would be less useful to companies as a means of comparing the relative skills and expertise of rival companies.[24]

Impact on the negotiating position of companies between tenders

27. EY said that a period of ten years would provide significant scope for companies to decide to initiate a tender at any time, but that shorter periods including the proposed five- or seven-year period proposed would tend to increase the focus of competition at set intervals, the effect of which would be to limit the effectiveness of ongoing competition.[25]

28. KPMG said that under mandatory tendering remedy any company which tendered for audit services outside of the prescribed window would be more likely to send adverse signals to investors as these companies would be more likely to be dissatisfied with its current audit provider and less likely to be tendering simply for good governance reasons. KPMG said that the impact this would have on competition outside of prescribed tender windows could have an impact on all of the parameters of competition on which audit firms compete, including quality, innovation and price.[26]

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[24] EY response to the Remedies Notice, Annex 2, paragraphs 2.5 & 2.6.
[25] EY response to the Remedies Notice, Annex 2, paragraphs 2.7 & 2.8.
[26] KPMG response to the Remedies Notice, paragraphs 3.2.5.3 & 3.2.5.5.

Impact on barriers to entry

29. PwC said that the CC had not explained why such a substantial increase in tenders was necessary to achieve its objective. For example, Mid Tier firms could expect to be provided with many more opportunities to tender for FTSE 350 audits under the new FRC changes than was currently the case.[27]

Impact of more frequent tendering on audit quality

30. KPMG said that more frequent tendering could be expected to result in an increase in costs of conducting audits. In particular, if auditors were to maintain the same level of quality on their existing audits, audit firms would be required to hire additional professional staff to manage the increased tender workload. If unable to hire the necessary number of professional staff (in particular highly skilled senior resources) to manage this increased workload, there would be a detrimental impact on audit quality.[28]

31. KPMG said that it was highly unlikely that the profession as a whole would be able to hire significantly more of the most highly skilled, experienced and senior resources to meet these additional demands, particularly in the case of the most significant and complex FTSE 350 clients and those clients with specialist requirements that require particular expertise (ie certain clients in the financial services industry).[29]

Cost of conducting more frequent tendering

32. Big 4 firms said that tendering at least every five or seven years would result in substantial costs being incurred by both companies and audit firm. The firms noted

[27] PwC response to the Remedies Notice, paragraph 3.26.
[28] KPMG response to the Remedies Notice, paragraph 3.2.2.8.
[29] KPMG response to the Remedies Notice, paragraph 3.2.7.1.

the CC's provisional findings in relation to the costs incurred by companies and firms in a tender process.[30]

33. KPMG estimated that: *(a)* the costs to all audit firms of participating in additional tenders over and above the current requirements of the FRC UKCGC would amount to approximately £[26-36] million (under a seven-year mandatory tendering remedy) and £[60 to 70] million (under a five-year mandatory tendering remedy) per year; and *(b)* the costs to FTSE 350 companies of conducting additional tenders (based on estimates of the opportunity costs of management time) would amount to approximately £6.6 million (under a seven-year mandatory tendering remedy) and £15.4 million (under a five-year mandatory tendering remedy) in total per year.[31]

34. KPMG also said that increased tendering would impose additional administrative costs on audit firms. Any time an auditor participates in a tender, it had to identify the provision of NASs that could breach independence with the potential client, and all the participating firms would not offer new prohibited NASs until they know whether or not they have been successful in the audit tender. With the increased rate of tendering, audit firms were less likely to be able to resolve all such issues which might reduce the number of audit firms participating in a tender. In addition, audit firms were likely to be less able to shoulder all of these costs of resolving independence issues and instead may have to pass them on to FTSE 350 companies as part of their audit fees.[32]

35. The Big 4 firms said that there was no basis for expecting that the costs of tendering would be reduced with more frequent tendering. Deloitte said that given the importance of obtaining a high quality audit, companies were committed to a proper

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[30] PwC response to the Remedies Notice, paragraph 3.28; Deloitte response to the Remedies Notice, paragraphs 3.11–3.13.
[31] KPMG response to the Remedies Notice, paragraph 3.2.1.3 a) and b).
[32] KPMG response to the Remedies Notice, paragraphs 3.2.8.1–3.2.8.8.

assessment of potential auditors' capabilities and firms were committed in the tender process to giving an effective account of themselves. This implied a thorough but costly tender process.[33] KPMG said that audits were bespoke and so there were very few, if any, economies of scale associated with the participation in audit tenders and so the cost per tender was likely to remain unchanged regardless of the number of tenders an audit firm participates in.[34]

Open-book tenders

36. The Big 4 firms welcomed measures to improve effectiveness and efficiency of the tender process and support guidance from FRC to companies on how to conduct tenders, but with the exception of EY were not supportive of an open-book process.[35]

37. PwC said that access to the existing auditor's working file on a tender should not be permitted, because this could: result in a breach of client confidentiality; stifle innovation by audit firms; compromise the benefit of a 'fresh approach'; and increase bidding costs given the resources required to review the files.[36]

38. KPMG said that open-book would undoubtedly increase the costs for companies in assembling and disseminating the information. To the extent that this referred to the incumbent audit firm's files, the expectation that all potential bidders would have conducted a thorough review of the additional information in preparing their proposals was likely to result in additional time commitments for the incumbent audit firm and other bidders.

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[33] Deloitte response to the Remedies Notice, paragraph 3.15.
[34] KPMG response to the Remedies Notice, paragraph 3.2.2.13.
[35] PwC response to the Remedies Notice, paragraphs 3.34 – 3.36. EY response to the Remedies Notice, Annex 2, paragraph 2.6.
[36] PwC response to the Remedies Notice, Annex 3, paragraph 3.

39. KPMG also said that open-book would involve the incumbent audit firm being required to share its audit methodology and approach with competing auditors participating in the tender. These may include the details of commercially sensitive aspects such as project management, time allocation or ancillary reporting to management, or any other innovative aspects of the offer, including on efficiency of delivery of services. Firms would anticipate the inability to maintain proprietary knowledge of the specific aspects of their offer and therefore be less incentivized to develop them in the first place. KPMG said that this would inevitably lead to lower differentiation between firms and a lower degree of product and process development for the market as a whole.[37]

40. KPMG added that whilst difficult to quantify the costs, any reduction in these incentives to compete would be expected to impose a very substantial cost on companies, shareholders and investors. The economics literature was clear that the impact of adverse effects on innovation was far more detrimental to consumer welfare than adverse effects on price. Therefore the impact on consumer welfare from a loss of innovation was likely to be at least as great as the part of the economic costs that we have quantified.[38]

41. Deloitte said that in managing a tender process that allowed bidders to have access to relevant information from the incumbent auditor, there needed to be an appropriate balance between necessary disclosure and appropriate retention of strategic and/or commercial information.

42. EY would welcome tenders conducted on an open-book basis as an approach to ensuring that bidders had access to the information necessary to submit more coherent and focused bids which reflected the bespoke elements of a company's

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[37] KPMG response to the Remedies Notice, paragraph 3.2.7.6.
[38] KPMG response to the Remedies Notice, paragraph 3.2.7.7.

accounting and control environment. EY did not expect an open book approach to reduce the costs of tendering as these costs were a function of the process adopted by the company, and could be expected to increase the costs of tendering if bidders were expected to demonstrate greater insight and understanding of the company.[39]

43. To be effective, EY said that an open-book approach would involve ACs working with the incumbent auditor to develop a document that provided the set out, for example:

(a) the principal audit risks and an attendant commentary on whether these reflect risks within the business or in the control environment, or both;

(b) the staffing model deployed to respond to these risks;

(c) a breakdown of audit hours by grade of staff in relation to each audit area; and

(d) a description of any single audit issue that accounted for (for example) more than 5 per cent of audit hours at a parent company or at a subsidiary level.[40]

Mid Tier firms

44. Mid Tier firms supported mandatory and more frequent tendering.

Appropriate time frame

45. BDO said that seven years would be the appropriate time frame for requiring mandatory tendering. BDO said that it understood all the investors interviewed by Oxera to be supportive of more frequent tendering of audits, which was widely expected to improve the quality of audits by providing a regular opportunity for ACs to step back and reflect on the quality and independence of the incumbent auditor.[41]

46. GT said that a logical approach which was widely supported by other investors and stakeholders would be audit partner rotation at five years and mandatory tendering at

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[39] EY response to the Remedies Notice, Annex 2, paragraph 2.11.
[40] EY response to the Remedies Notice, Annex 2, paragraphs 2.7(a), 2.10 & 2.12.
[41] BDO response to the Remedies Notice, paragraphs 1.2.1 & 1.3.1.

a maximum of ten years. Mazars, Kingston Smith and Crowe Clark Whitehall agreed.[42] GT considered that this would provide the incumbent audit firm with significant motivation to continue as audit firm. GT said that there was significant competition for one-off transactional non-audit assignments for fees far smaller than a potential five-year audit fee provides evidence that would be the case.[43]

Mandatory or 'comply or explain'

47. BDO said that the remedy should be mandatory and that any exceptions should therefore be narrowly defined.[44]

48. GT said that there was a danger that in a comply or explain regime the easier option would be to explain rather than choosing to comply, but that it would be important to take note of the views of other stakeholders, especially shareholders, about whether there would be a role for a continuing comply or explain framework, with the potential to introduce mandatory tendering subsequently if that did not work. GT considered a requirement to tender every five years would be too aggressive.[45]

Impact on competition

Impact on the competitiveness and effectiveness of tenders

49. BDO said that more frequent tendering would increase the ability for companies to make an informed choice of auditor which would increase companies' bargaining power and the incentives for auditors to compete.[46] BDO also said that it would

[42] Mazars response to the Remedies Notice, section 9; Kingston Smith response to the Remedies Notice, section 1; and Crowe Clark Whitehall response to the Remedies Notice.
[43] GT response to the Remedies Notice, paragraphs 1.9 & 1.10.
[44] BDO response to the Remedies Notice, paragraph 1.4.1.
[45] GT response to the Remedies Notice, paragraph 1.5.
[46] BDO response to the Remedies Notice, paragraph 1.6.3.

encourage greater differentiation between audit firms, as firms sought to distinguish themselves by their audit service, approach and philosophy, not just on price.[47]

50. BDO said that for the remedy to be effective, it would be necessary to ensure that criteria specified by companies did not amount to a de facto 'Big-Four-only' requirement. The process should therefore be subject to review by an independent assessor.[48]

51. BDO said that AEP rotation and mandatory tendering must be aligned, so that if tendering were to take place every seven years, so should AEP rotation. BDO said that this would increase the likely beneficial effect of tendering, as companies would approach a tender in a more open-minded manner if they knew that their incumbent auditor would have to rotate its AEP even if it retained the work. If AEP rotation remained on a five-yearly cycle, companies might well be more reluctant to switch auditor relatively recently after they had switched AEP.[49]

Impact on barriers to entry

52. BDO said that provided that tenders were not restricted to the Big Four in practice, the remedy would provide greater opportunities for audit firms outside the Big Four to tender for FTSE 350 audits[50] and facilitate increased awareness among FTSE 350 companies of the capabilities, experience and approach of Mid Tier firms.[51] GT made a similar point.[52]

53. Mazars said that there could not be a high degree of assurance that mandatory tendering would provide many real new opportunities for non-Big-4 firms unless

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[47] BDO response to the Remedies Notice, paragraph 1.6.3.
[48] BDO response to the Remedies Notice, paragraph 1.5.4.
[49] BDO response to the Remedies Notice, paragraph 1.8.2.
[50] BDO response to the Remedies Notice, paragraph 1.6.3.
[51] BDO response to the Remedies Notice, paragraph 1.6.3.
[52] GT response to the Remedies Notice, paragraphs 1.3 & 1.7.

accompanied by other measures.[53] Kingston Smith and Crowe Clark Whitehall made a similar point.[54]

Impact on fees and audit quality

54. BDO said that more frequent tendering would reduce the incentives of auditors to compete to satisfy management (rather than shareholder) demand, by limiting the influence of management on retendering by providing, other than in unusual situations, a settled period of auditor appointment. This would enhance the independence of auditors from executive management.[55]

Costs of conducting more frequent tendering

55. BDO considered that the actual costs of this remedy were likely to be exaggerated as a result of widespread misapprehensions about the difficulties and costs of tendering. Although FTSE 350 companies were generally used to conducting tenders for other professional services, such as legal services, they tended to have less experience of tendering for their statutory audit. They were often discouraged by their existing auditors from going out to tender, because the existing auditors wished to protect their position and preserve the status quo.[56] BDO also said that aspects of the tender process (such as documentation inviting expressions of interest and invitations to tender) could be relatively standardized, particularly if companies used specialized procurement consultants to help them run the process.[57]

56. GT said that it was almost inevitable that with more frequent tendering the unit costs of tendering would fall as companies and audit firms became more familiar with efficient and effective tendering processes as audit firms would be forced to focus

[53] Mazars response to the Remedies Notice, section 9.
[54] Kingston Smith response to the Remedies Notice, section 1; Crowe Clark Whitehall response to the Remedies Notice.
[55] BDO response to the Remedies Notice, paragraph 1.6.3.
[56] BDO response to the Remedies Notice, paragraph 1.6.2.
[57] BDO response to the Remedies Notice, paragraph 1.6.1.

their tender efforts solely on audit quality and not the other matters that often go into the tender effort at present.[58] GT also said that audit firms would become more selective in accepting an invitation to tender.[59]

Open book

57. BDO would welcome an open-book process.[60] Kingston Smith said that it could see benefits to an open book process but was not convinced that this would reduce costs.[61] Crowe Clark Whitehall had serious reservations about the appropriateness of an open-book process as it could stifle innovation and would not significantly assist the process.[62]

Transitional provisions

58. BDO said that it would be appropriate to phase in this remedy, or a great many companies could be going out to tender for their statutory audit as soon as this remedy was introduced. BDO considered that companies with the longest audit tenure should be required to tender first within a specified period. BDO submitted a proposal that would require within four years and six months of a specified date (eg 1 April 2014) all companies which had not changed audit firm within the last five years to conduct a tender for their statutory audit.

59. GT said that there must be transitional provisions, which would phase in the requirements to tender. GT said that the objective should be to move to the position where the tender requirements were evenly distributed through time.

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[58] GT response to the Remedies Notice, paragraph 1.15.
[59] GT response to the Remedies Notice, paragraph 1.31.
[60] BDO response to the Remedies Notice, paragraph 1.5.3.
[61] Kingston Smith response to the Remedies Notice, section 1.
[62] Crowe Clark Whitehall response to the Remedies Notice.

Regulators

The FRC

60. The FRC said that the new provision in the UKCGC appeared to be working well and that the provision should be given time to take effect before further changes were made. The FRC also said that there was no guarantee that mandatory tendering would reduce concentration and that concentration may increase as non-Big-4 firms found their existing audits put to tender.

61. The FRC would be concerned about a mandatory requirement to tender. Comply or explain was said to be an important facet of the UK governance regime. Its latest survey suggested a 90 per cent compliance rate. Such a regime was said to have allowed the UK's governance regime to develop further and more quickly than would otherwise be the case and to appropriately recognize the role of the investor in its enforcement. The FRC was concerned that mandatory tendering could lead to retendering in an inappropriate years contrary to investor's interests.

Canadian Public Accountability Board

62. The Canadian Public Accountability Board was concerned that mandatory tendering would have unintended consequences, in particular that audit firms would devote more resources to business development, proposal activities and managing the tendering process which would likely mean fewer resources available to support audit quality.

63. It was not aware of compelling evidence that mandatory tendering would lead to improved audit quality, but might have led to a substantial reduction in audit fees in some jurisdictions. It was concerned that mandatory tendering might lead to increased price competition, but that the audit would become a commodity to be

differentiated on price and not quality. A race to the bottom on fees would not be in the shareholders' interest.

64. The Canadian Public Accountability Board said that mandatory tendering could also limit choice in specialized industries thereby negatively impacting audit quality. In circumstances where a non-auditor firm was providing substantial consulting services to a company it might not be willing to forego this work to become the auditor, thereby actually reducing the potential choices to only one or two others. In an environment of mandatory tendering there might be less incentive for auditors to take a tough stand on material issues when that could impair their chances of success in the upcoming tendering process.

Investor community

AXA Investment Managers

65. AXA supported the FRC's ten-year period on a comply or explain basis. AXA said that this struck the appropriate balance with a concern that a shorter tenure might deter auditors from taking on complex clients. A comply or explain basis was said to put a strong presumption on companies to put the audit to tender within the defined period. Companies deviating from this requirement would have to disclose and explain to shareholders who can use their voting rights on the appointment of auditors or indeed election of directors to sanction companies whose explanations were not considered acceptable. AXA believed that the requirement to comply or disclose and the necessary transparency would shift market behaviour.[63]

Baillie Gifford

66. Baillie Gifford said that, on balance, its view was that companies should be required to tender more frequently than every ten years. If the idea was to initiate change, the

[63] AXA Investment Managers response to Investor questionnaire.

recommendations should be sufficiently different to current practices as to require management and ACs to reconsider their relationships with their auditor. Baillie Gifford supported five years on a comply or explain basis. Baillie Gifford acknowledged that there were currently significant costs associated with the tender process and so supported the proposals to conduct the tendering process on an open-book basis.[64]

Hermes

67. Hermes supported ten-year mandatory tendering but did not regard this as a significant change from the FRC's comply or explain approach as it would not expect many explanations under that system—only when short-term tensions meant that a tender was not appropriate.[65] Hermes favoured a comply or explain approach but would be content to agree to a switch to mandatory tendering.

68. Hermes said that the benefits of mandatory tendering would markedly outweigh the costs. It suggested that the greater transparency provided by the disclosures on audit scope, risks and materiality under the FRC's current auditor reporting proposals would provide rival bidders with a substantial basis for assessing where to pitch their bids, in particular in terms of how to enhance audit quality. This should markedly simplify and facilitate the tendering process.

69. Hermes also said that mandatory tendering at ten years struck the right balance between requiring an active consideration of refreshment of the auditor while not causing excessive disruption. It would not welcome five or seven years being applied.

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[64] Bailie Gifford response to Investor questionnaire.
[65] Hermes response to the Remedies Notice.

70. Hermes welcomed the flexibility provided by the comply or explain approach. It expected that such flexibility would only be exercised in rare cases where there was a significant reason why potentially disrupting the audit would be inappropriate (such as a major transaction or financial problems which threaten the future of the business), and it expected that shareholders would provide active oversight to ensure that this flexibility was not abused. Hermes said that it would be unfortunate if companies were compelled to mount a tender in such rare circumstances—when the only possible result would be the reappointment of the incumbent. Hermes believed that there should not be significant costs from mandatory tendering, particularly if this was done on the open-book basis envisaged by the CC. It certainly believed that the benefits would outweigh the costs.

National Association of Pension Funds[66]

71. NAPF said that seven years would be the appropriate time frame. It considered that priority should be to ensure auditor independence was protected and that it should be with the AC that accountability for this is placed. It recognized that companies vary in size and complexity and therefore there should be sufficient flexibility within any governance system to allow for this to be accommodated.

Royal London Asset Management

72. Royal London Asset Management (RLAM) said that overall it favoured more opportunities to create movement in the market for audit services. It believed that placing reliance upon purely comply or explain would not necessarily lead to greater movement and it therefore favoured greater compulsion. RLAM suggested a requirement to tender at five to seven years on a comply or explain approach and mandatory tendering at ten years. This, it said, would prevent the possibility of the Board continuously using the comply or explain route to never move to a formal

[66] NAPF response to the Remedies Notice.

retender. RLAM was unconvinced that this process should lead to significantly higher costs, but if it did the price would be worth paying if the result was a greater degree of confidence in the overall market for audit.

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73. [✂] said that it was not clear why mandatory tendering more frequently than every ten years would create a notable benefit for investors or that this would lead to an increase in competition. [✂] said that more frequent tendering would increase the cost to firms of audit and that the increase in cost would no doubt be passed on to companies and, therefore, their shareholders. The tender process can be time-consuming for audit firms and generally involved senior members of the firm.

Other

74. [✂] said that there were pros and cons to more frequent tendering than every ten years and that it was not obvious that five or seven years was the best period. It said that audit might be cheaper, but there would perhaps be a tendency to cut corners. It would result in fresh reviewer but by people with less history and experience. [✂] favoured mandatory tendering to a comply-and-explain-based obligation as there would always be opportunities to 'explain'.

75. Legal and General Investment management supported 15-year mandatory tendering of the external audit contract. It agreed with the CC proposals that tendering should be conducted on an open-book basis. It considered that this would give the AC more information to better judge the quality of audit the firm competing for the contract might provide and make better judgements on negotiating fees.[67]

[67] L&G Investment Management response to the Remedies Notice.

76. [✂] said that tendering more frequently than every ten years would not benefit shareholders due to the significant cost and disruption to the company. The costs could be expected to exceed the benefits.

77. Newton Investment Management favoured tendering every five to seven years on a comply or explain basis.

78. A coalition of six investors and a body representing 56 local authority pension funds supported mandatory tendering as proposed by the CC.[68]

UK Industry bodies

Association of British Insurers

79. ABI supported the new FRC provisions and considered that these could improve competition. The early signs were said to be encouraging and ABI considered that these should be given more time. They did not accept that comply or explain undermined effective compliance given evidence on the high rate of compliance, and considered that a cogent and coherent 'explanation' should remain a valid approach. ABI considered that there should, however, be more accountability and transparency to shareholders on the tendering process. We considered these points in the assessment of remedy 5.[69]

Chartered Institute of Management Accountants

80. CIMA was concerned that mandatory tendering would be a disincentive for audit firms to establish specialist auditing skills in certain industry sectors and that the costs of undertaking a retendering process were not inconsiderable. Nevertheless, it acknowledged concern over the length of time some companies have used the same

[68] USS Investment Management, RPMI Railpen, National employment Savings Trust (NEST), Local Authority Pension Fund Forum, London Pensions Fund Authority, Governance for Owners and Environmental Agency Active Pension Fund response to the CC's Remedies Notice.
[69] ABI response to provisional findings and the Remedies Notice.

audit firm and have concluded that the greater transparency that a tendering process would deliver could be beneficial in alleviating these fears. However, it believed the new FRC provisions to be sufficient.[70]

Confederation of British Industry

81. The CBI supported the new FRC provisions. It believed it would prompt companies into testing the market and to consider a new auditor whilst ensuring that the decision ultimately remained in the hands of the AC and shareholders to decide on the firm best placed to conduct the audit.[71]

GC 100

82. GC 100 is the association for the general counsel and company secretaries of companies in the UK FTSE 100. It supported the new FRC and believed that this new regime should be allowed to operate for a few years before any further changes are made. It considered the ten-year period to be about right given the work involved both for the company and for the auditor and prospective auditors both in the tendering period and, should a change of auditor be the outcome, in the early years of educating the new auditor about the company. It also believed it important to retain the comply or explain basis as there could always be some intervening event that made it inadvisable to tender the audit in year ten, for example when there is a new CFO, new Chairman of the Audit Committee or takeover activity.[72]

83. It did not understand how tendering the audit every ten years necessarily increased the likelihood of more Mid Tier firms being appointed auditors to FTSE 350 companies. It believed that Mid Tier firms were put off tendering for FTSE 350

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[70] CIMA response to provisional findings and the Remedies Notice.
[71] CBI response to provisional findings and the Remedies Notice.
[72] GC 100 response to provisional findings and Remedies Notice.

contracts because of the time and resources required both during the tendering process and immediately after appointment.[73]

Hundred Group of Financial Directors

84. The Hundred Group of Financial Directors supported the new FRC provisions and believed that it was already leading to better tendering and suspected that Boards were starting to take this far more seriously than they had in the past as part of their overall Governance considerations.[74]

Institute of Chartered Accountants in England and Wales

85. The ICAEW supported the new FRC provisions. It said that it was too early to assess whether the comply or explain provisions would have an effect and should be given time to bed down. It considered that ten years fitted well with the current requirements for the engagement partner rotation every five years.[75]

86. The ICAEW said that the CC underestimated the power of disclosure to shareholders and the value of having 'explain' as a genuine alternative to 'comply'. In addition a comply or explain approach at least partially recognized that any fixed period was by definition somewhat arbitrary and not suitable for all companies. This was because the cost/benefit relationship will vary from company to company and would be dependent on factors such as size, industry, and date of last change.[76]

87. The ICAEW said that proposals for open-book access were interesting, but it would be concerned if such an approach led to a stifling of innovation or an increased focus on cost rather than audit quality. The impact might also be limited if a reduction in pre-tender engagement reduced their ability to assess the potential auditors, and that

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[73] GC 100 response to provisional findings and Remedies Notice.
[74] FD 100 Group response to provisional findings and Remedies Notice.
[75] ICAEW response to provisional findings and Remedies Notice.
[76] ICAEW response to provisional findings and the Remedies Notice.

there were potential issues of confidentiality (as required by the professional code of ethics), liability and commercially sensitive information.[77]

Institute of Chartered Accountants of Scotland

88. The Institute of Chartered Accountants of Scotland (ICAS) said that the new FRC provisions should be given the time necessary to see whether it had had the desired effect. It said that there was evidence that the FRC's approach was leading to increased activity in the marketplace such as the recent change of auditors at several companies, and that it was questionable whether companies should be forced to retender on a more regular basis. It also questioned the need for retendering to mandatory given the high level of compliance with individual Code provisions across all FTSE 350 companies.[78]

89. It said that it would be unfortunate if the comply or explain approach were perceived to be weak by an authoritative UK body and therefore might inadvertently lead to other corporate governance measures being mandated in EU law which would remove the level of flexibility that better allowed companies to put in place governance measures which best met their specific requirements.[79]

90. The ICAS said that it was imperative that a tendering process should not be seen as a cost reduction exercise, as this should not be the main reason for reviewing the audit relationship. It should be more about quality, service, and best practice which add value to the company and shareholders rather than just lowering the cost. Although there should be an element of cost competition, the audit fee agreed should

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[77] ibid.
[78] ICAS response to provisional findings and the Remedies Notice.
[79] ibid.

be adequate to perform a quality audit. In its discussions with AC members they were said to have been very much in line with this rationale.[80]

The Investment Management Association[81]

91. The Investment Management Association (IMA) said that for many investors requiring tendering every five or seven years was too frequent. It supported the new FRC provisions. There was said to be a certain amount of learning with any new assignment and a longer period allowed auditors time to acquire a detailed knowledge of the audited entity and perform a more effective audit over that period. This was said to be particularly important for complex multinational groups. It also meant the auditor could adapt the audit approach more effectively in response to changes in the environment or internally to the entity.

92. The IMA also said that a significant minority of investors would like to see tendering every five to seven years.[82] It considered auditors could lack independence from a company's management which played a key role in their appointment and remuneration and that more frequent tendering could help address this.

93. The IMA said that it would be difficult to envisage a convincing explanation of a decision not to tender after a tenure of 15 years. Thus investors would support the introduction of a 'mandatory tendering' requirement after at least 15 years. It considered this could help improve competition and noted that many other commercial relationships were subject to regular tendering.

94. Investors are said not to support mandatory tendering as it should be for companies, their boards of directors and ACs to decide when the audit should be tendered in

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[80] ibid.
[81] IMA response to the Remedies Notice.
[82] Ibid, paragraph 20.

consultation with their shareholders. The remedy would disenfranchise both ACs and shareholders. In addition, the IMA said that a tender process could be costly and time-consuming for both companies and auditors, and there should be some flexibility where continuity of auditor might be important such that alternative firms would not be seriously considered.

95. The IMA said that it understood that a tender process could be costly and time-consuming for both companies and audit firms. It did not necessarily agree with the CC that a more frequent system of tendering would reduce the resources expended—auditors would be concerned about losing market share and would continue to devote the same resource to such exercises. It said that this would ultimately be reflected in increased audit fees. It considered that companies would also expend time and resource to ensure that potential candidates had adequate information and understanding of their operations, controls and reporting policies and procedures.

96. The IMA said that an open-book process would raise issues around client confidentiality that might restrict auditors providing such access to their competitors, but that this was a matter for the audit firms to comment on.

The International Federation of Accountants

97. The International Federation of Accountants (IFAC) said that there were potentially very high costs—monetary, human, and time—involved in a tendering process for the company and audit firms, and that the entire cost structure for auditing would rise across the board with no guarantee that it would enhance audit quality.[83]

[83] IFAC response to provisional findings and the Remedies Notice.

98. The assertion that 'under a more frequent system of tendering, resources expended by firms in mounting bids and companies in assessing bids would be reduced in view of the greater frequency of tendering' did not seem to consider: the potentially larger number of audit firms submitting bids; the potentially larger number of bids that organizations would need to assess; changes in staff in the organizations undertaking the assessments; the potentially larger number of bids that each audit firm might decide to make; and changes in audit firm staff over time.[84]

99. The IFAC also said that regular tendering could divert the attention of the AC, management, and the auditors from their ongoing responsibilities for financial reporting and auditing.[85]

100. IFAC was strongly opposed to an open-book process as it would present enormous difficulties for auditors who were bound to ethical codes that were founded on the notion of confidentiality as a basic principle. The proposal also failed to consider the importance of 'trust' in the auditor-company relationship, as well as potentially increasing the auditor's liability exposure.[86]

Non-UK bodies

Canadian Public Accounting Board—Enhancing Audit Quality Steering Group

101. The Canadian Public Accounting Board did not support mandatory tendering because of the potential negative consequences to audit quality and associated corporate governance. It considered that the intrusion into the marketplace for audit services to be disproportionate to the significance of the problem, eg institutional familiarity risks given that other alternatives exist. It raised the following points:[87]

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[84] ibid.
[85] ibid.
[86] ibid.
[87] Canadian Public Accounting Board response to provisional findings and Remedies Notice.

(a) The timing for tendering of the audit was best left to the judgement of the AC, not based on an arbitrary rule. Using an arbitrary time frame for a change could cause hardship for a company if it would occur at an inopportune time (eg when a major transaction was occurring) and would not then be in the best interests of the company's shareholders.

(b) The tendering process might be focused on audit fees rather than audit quality. Competitive pressure on fees in the audit market over time could negatively impact audit quality.

(c) There might be an increased self-interest threat as an auditor may not challenge management as aggressively as before because of the fear of losing the audit engagement as the firm approaches the tendering period.

(d) AC focus could be more on evaluating potential new audit firms and audit fees, rather than on the audit quality and independence of the incumbent firm.

(e) Mandatory audit firm tendering would add time and costs for both management and the external auditor—even though the same external auditor might well be appointed. The company would also incur costs for educating new external auditors (if a new auditor is appointed) on the company's operations, systems, business practices, and financial reporting processes. Shareholders indirectly bear these costs.

(f) The choice in a successor external auditor could be limited because providers of certain NAS to the company would be ineligible to be appointed as the new external auditor. Companies in specialized industries (eg financial institutions) or with a global footprint could be particularly affected by such a limited choice.

Confederation of Swedish Enterprise and Institute for the Accountancy Profession in Sweden

102. These bodies said that shareholder involvement in the appointment and dismissal of a company's auditor should be strong and that it was the fundamental right of the owners to make the decisions in the process of evaluating and appointing the auditor.

They considered that there were other more efficient ways of getting shareholders engaged than by mandatory tendering and firm rotation, in particular the continued development of Nomination Committees. They were also not aware of analyses or international experiences that showed mandatory tendering increased competition within the audit market for larger entities.[88]

Hong Kong Institute of Certified Public Accountants

103. The Hong Kong Institute of Certified Public Accountants did not believe that there was evidence to show that mandatory tendering would have a positive effect on audit quality or in opening the market for more participants to provide audit services to large companies. It considered that these were areas where a strong and effective AC should take appropriate action to ensure the company and shareholders received a quality audit at a fair cost. It was also concerned that legal and practical consequences of an open-book process had not been fully considered.[89]

The Institute of Chartered Accounts Australia

104. The Institute of Chartered Accounts Australia considered that a measure such as mandatory tendering should be proposed only if there was unequivocal evidence on the need and benefit which could not be catered for through other means. ACs were charged with the oversight and review of the external audit and were well placed to assess the effectiveness of the audit and the appropriateness of their reappointment.[90]

The South African Institute of Chartered Accountants

105. The South African Institute of Chartered Accountants supported the new FRC provisions. It did not think that there was one specific defined time period in which a

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[88] Confederation of Swedish Industry and Institute for the Accountancy Profession response to provisional findings and the Remedies Notice.
[89] Hong Kong Institute of CPA response to provisional findings and Remedies Notice.
[90] Institute of Chartered Accountants Australia response to provisional findings and Remedies Notice.

tender should take place and for this reason supported a comply or explain approach which had a long and successful tradition in the UK. It considered that a timescale of five or seven years would not strike the right balance between costs and benefits for the largest companies (and their shareholders).[91]

Individuals

106. Simon Laffin is a qualified accountant with experience as Board and Audit Committee member over the last 19 years. He is currently the chairman of a listed UK company and chairman of the audit committee for two UK listed companies, and had been the CFO of a FTSE 100 company and served as audit committee chairman on two other significant listed companies.

107. He was not convinced that mandatory tendering would improve the alleged AEC of auditor concentration. He said that mandatory (as opposed to comply or explain) tendering would potentially cause adverse effects in forcing companies to tender for an audit at times that management efforts need to be focused on more pressing or urgent matters. He also noted that more frequent tendering was already being introduced as a governance requirement, and the evidence was that compliance with corporate governance comply or explain requirements was very high. Nevertheless, he believed that as a matter of good practice every supplier should retender from time to time. In this respect a seven- to ten-year best practice (comply or explain) benchmark was appropriate.

[91] South African Institute of Chartered Accountants response to provisional findings and Remedies Notice.

Estimate of the costs to companies of more frequent tendering

Firms' views

1. Deloitte estimated the costs of participating in tenders for the following types of company: FTSE 100 non-financial companies with operations in a number of countries; a complex financial institution; a relatively simple financial institution; and FTSE 350 companies with subsidiaries in a few countries. Deloitte estimated staff costs at [✂] per cent RRR. It said that this was indicative of the opportunity cost of the charged time of those individuals participating in the tender. Deloitte said that, excluding the results for a large financial institution, the range was £[✂] to £[✂] for staff costs and £[✂] to £[✂] including expenses (at 2011 scale rates). For a large financial institution these figures were £[✂] and £[✂] respectively. Deloitte also said that its current expenditure on the [✂] tender was already over £[✂].

2. KPMG estimated the additional cost to be approximately £26 million or £60 million per year, if the remedy is implemented on a seven- or five-yearly basis respectively. These were based on a cost for each tender process of between approximately £990,000 and £2,400,000 (assuming participation of three firms), with an average cost of £1,700,000 per tender. These estimates were said to assume the current level of effort and resource on the part of audit firms.[1]

3. KPMG said that it had used the CC's estimated range for the cost to audit firms of participating in a tender as a percentage of the first year's audit fee (23 per cent and 57 per cent) and multiplied these figures by the CC's estimate of the average audit fee.[2,3] KPMG also said that it would need to increase the resources of its bid team that supported tenders and proposals. The dedicated bid team was said to be

[1] KPMG response to the Remedies Notice, paragraph 3.2.2.5.
[2] It appears that KPMG used a figure of £1,430,000 for the average audit fee. This is close to the figure for 2001 in 2005 prices.
[3] KPMG response to the Remedies Notice, footnote 33.

currently composed of [✂] members of staff with salary costs of approximately £[✂] million per year. This team spends approximately [✂] per cent of its time exclusively on FTSE 350 audit tenders. In response to the anticipated increased rate of tendering as a result of the changes to the Governance Code, KPMG was committed to employing a further [✂] members of staff at an additional salary cost of £[✂] million per year, plus £[✂] million of further investment such as updates to the web portal, an additional bid room and other necessary resources. KPMG estimated that a further increase in tendering to every seven and five years would cost an additional £[✂] million or £[✂] million per year, respectively. Assuming the other firms had similar internal central support teams, KPMG estimated that this would contribute between £[✂] million and £[✂] million to the cost of the CC's proposals.[4]

CC comments on KPMG's cost estimates

4. KPMG's figures are based on results presented in the provisional findings which used scale rates as an estimate of the opportunity costs of the time allocated to tenders. We said in the provisional findings that this approach would result in a considerable overestimate (see provisional findings, Appendix 24 ('Analysis of tender data'), paragraph 37).

5. In Table 1 below we set out a comparison of scale rates with staff costs. These figures show that scale rates exceeded staff costs by a factor in the range of around [✂]. In the provisional findings we presented results on the RRR achieved for audit engagements which provide a measure of how fees earned have compared with scale rates (see provisional findings, Appendix 5 ('Descriptive statistics'), Figure 21). These results indicate that [✂] achieved an average RRR on its FTSE 350 audit engagements over the period 2006 to 2011 of around [✂] and [✂] around [✂] per

[4] KPMG response to the Remedies Notice, paragraphs 3.2.2.9 & 3.2.2.10.

cent. [✂] estimated the opportunity cost of time charged to a tender at [✂] per cent of scale rates.

TABLE 1 **Scale rates and actual cost per hour (based on chargeable hours) 2011**

	DEL			*EY*			*KPMG*			*PwC*		
	Scale	*Actual*	*Ratio*	*Scale*	*Actual*	*Ratio*	*Scale*	*Actual*	*Ratio*	*Scale*	*Actual*	*Ratio*
Director	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Senior Manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other qualified	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Unqualified	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CCanalysis.

6. KPMG did not agree that use of scale rates would overstate the true opportunity costs of time spent by audit staff preparing tenders as the time devoted by audit staff to the tenders analysed may not have been dedicated to audit work, or could not have been billed in its entirety at full scale rates. KPMG argued that with more frequent tendering it was more likely that audit firms would have to divert resources from audit work or other client engagements in order to participate in tenders.[5]

7. We do not accept that a requirement for companies to tender more frequently than every ten years could be expected to result in a diversion of resources away from other audit work of other client engagements. We consider that for a firm to respond in this way to a requirement to participate in more tenders would be a high-risk strategy for a firm if it would result in a reduction in audit quality. In addition, we would expect a diversion of resources from marketing activities. We would also expect firms to plan in the expectation that they would be asked to participate in more tenders than in the past. If diverting resources from other work would be more costly to the firm, we would expect the firm to recruit additional people in order to have the capacity to participate in tenders (see paragraph 3.117).

8. In relation to KMPG estimates of the staff costs to firms, we also note the following:

[5] KPMG response to the Remedies Notice, paragraph 3.2.2.4.

(a) The CC's figure of 23 per cent used by KPMG (see paragraph 3) was derived from data provided by [✂], a Mid Tier firm. The corresponding figures for the two Big 4 firms, [✂] and [✂], for which we had data were 29 and 57 per cent respectively.

(b) These figures are averages of the percentages calculated for each tender in which the firm participated (and provided data). These figures would have been lower had we calculated total staff costs across all tenders presented as a percentage of total first year fees; 13 and 26 per cent respectively. We consider that it would be appropriate to use these lower figures if these are to be applied to average audit fees.

(c) We note that [✂] estimated that on average tender preparation costs for companies that were in the FTSE 350 at the time of tendering were approximately [✂] per cent of the first-year fee bid submitted.

9. KPMG also argued that evidence from past tenders was unlikely to reflect accurately the full costs to audit firms of participating in tenders under a mandatory tendering regime because any increase in the amount of proposal work over and above current levels was likely to have a material impact on the staff requirements of audit firms. KPMG said that it had not included the costs of any additional professional staff in its calculations, nor the potential impact on professional staff salaries arising from increased demand in the market.

10. We agree that, as a matter of principle, additional demand for resources (particularly scarce resources) may be expected to result in an increase in the market rates charged. However, we consider that any diversion of resources is less likely to be from the delivery of audit services than from marketing activity. We have also noted that tenders are also often timed to be at quiet periods when the opportunity cost of staff would be lower. Finally, we consider that companies and firms will have an

incentive to become more efficient in the design of tender processes to reduce to costs to firms and companies of participating in tenders.

Audit Quality Review

Investment community

Submissions

1. The Investment Management Association (IMA) supported an increased frequency of AQRT reports and in greater granularity and the publication of company-specific reports. The IMA noted that different companies which owned the 'same instruments, for the same purpose' reported the value of these instruments differently, even though the same firm audited both, which would suggest the need for the AQR to consider the consistency of auditor judgement across engagements. The IMA emphasized the need for greater emphasis on professional scepticism and key judgements.[1]

2. Eight Institutional Investors (and additionally supported by the UK Shareholders' Association) stated that increased frequency of AQR reporting would be beneficial and that, as the ultimate beneficiaries of audit, shareholders should be privy to company-specific findings. However, if there was a 'cap' on auditor tenure, the need for more frequent AQR reviews would be diminished.[2]

3. The Chartered Financial Analyst (CFA) Society of the UK believed that the FTSE 350 should not be treated differently and AQR reviews should be every three years, which would be consistent with SEC requirements and focus on challenging audit judgements.[3]

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[1] IMA response to the Remedies Notice, 25 March 2013.
[2] USS Investment Management, RPMI Railpen, National Employment Savings Trust (NEST), Local Authority Pension Fund Forum (on behalf of 56 pension funds), London Pensions Fund Authority, Governance for Owners, Environmental Agency Active Pension Fund and Sarasin & Partners LLP response to the Remedies Notice, 19 March 2013.
[3] CFA Society of the UK response to the Remedies Notice, 14 March 2013.

4. The Association of British Insurers (ABI) did not believe that the AQR should move its focus away from companies considered to be a 'priority risk'. The ABI did, however, think more frequent inspections of higher-risk priorities and the provision of more detailed reporting to stakeholders would be useful subject to appropriate funding.[4]

5. Hermes Equity Ownership Services Limited (Hermes) stated that it was concerned to ensure that any inspection regime focused not on the technicalities and the paperwork associated with the audit but rather on ensuring the application of scepticism and the effective exercise of professional judgement, and that until this was clearly delivered through AQR reviews 'we would hesitate to make them more frequent'.[5]

6. Legal & General Investment Management (L&G) supported company-specific reporting as a way of improving the understanding of the audit process in companies in which L&G invested and to provide basis for engagement and holding ACs to account. L&G stated that there were limitations to the AQR process and was supportive of a self-regulatory audit market.[6]

Investor questionnaire

7. Investors identified AQR reports at present as having potentially two distinct purposes. The first was as a 'passport for quality' for a firm as a whole, encouraging behavioural change in firms and the second was to allow either management or potentially shareholders to understand the quality of their own audit.

8. Those investors who did refer to AQR reports considered them to be useful in assessing a firm's quality and how firms were dealing with key issues. Some

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[4] ABI response to the Remedies Notice, 26 March, 2013.
[5] Hermes response to the Remedies Notice, 18 March 2013.
[6] L&G response to the Remedies Notice, 20 March 2013.

investors and investor groups had either not had recourse to AQR reports themselves or did not believe their use to be widespread by member investors. One response on behalf of six investors and 56 pension funds stated that they rarely referred to AQR reports explicitly because of the lack of information on individual audits. An insurance trade group stated that they thought it difficult to envisage a situation where shareholders would refer to AQR reports on individual firms. One investor stated that it would not have time to review AQR reports for individual companies. However, some investors believed that if the content was to be improved, they would be of greater use and other investors believed that more regular or more thorough assessments could only be of benefit to shareholders. A number of investors supported increased frequency or widened scope. One investor considered them to be useful, but that to get greatest benefit it was felt one needed to 'read between the lines' to understand the nature of the issues being presented, but allowed the investor to challenge firms and another investor used them in dialogue as part of the dialogue requirements of the UK Audit Firm Governance Code. One trade association believed improvements to the AQR could lead to investors being better able to compare firms' quality.

9. One investor commented that the greater frequency of AQR reporting for the Big 4 firms might inappropriately indicate a hierarchy in the audit market.

10. A number of investors and investor groups observed that AQR from their perspective was the only independent assessment of audit quality. One investor noted that AQR was but one mechanism to assess audit quality and that the FRC was best placed to decide the scope and frequency of quality reviews.

11. One investor believed that increased frequency should be on a risk-assessed basis. Some investors identified every FTSE 350 company audit being reviewed every three

years to be desirable, which would bring the AQR's reporting cycle in line with the PCAOB's as required by the SEC. One investor thought that the nature of the review needed to be improved before considering increasing the frequency.

12. In respect to the scope of the AQR, some investors thought the AQR should focus more on challenging judgements rather than expanding the scope of the review and one investor believed a move away from a focus on paperwork to actively challenging judgements would be appropriate. One investor believed it would be useful to have more information on how firms had responded to the findings, such as on how they improved their reporting to the AC.

13. In respect to whether company-specific reports should be published views were mixed. Some investors supported the disclosure of company-specific findings, particularly where the audit had been challenged or controversial. One investor thought that the potential for public reporting would act as a greater incentive to ensure audit quality. A number of investors did not believe that disclosure of company-specific findings was appropriate, with some investors cautioning that, where material deficiencies were identified in the audit that might indicate the need to restate the financial statements, such results should be made public. One investor felt that the potential benefits that shareholders would obtain might not exceed the impact of potential negative publicity and another thought whilst it might be useful in a number of cases it might 'water down' the content of reports so would not ultimately be useful. One trade group for insurers noted that whilst this would be welcome to shareholders it would run the risks of the process becoming more adversarial and less open.

14. Some investors supported additional and more detailed disclosure to companies. One investor and a trade association favoured more information generally, with the

investor being against this at the company-specific level. A coalition of eight institutional investors supported the need for ACs to be obliged to report on the outcome of AQR and one investor said that the AC should have this option.

15. Some investors did not believe that the FTSE 350 should be different to other PIEs but the results of FTSE 350 audit reviews should be reported on as a subset.

16. Others were undecided if changes to AQR would impact on their utility to investors whilst others did believe this would lead to improvements.

Companies

Submissions

17. The Royal Bank of Scotland Group (RBS) questioned whether the remedy would have a significant effect on competition and noted that it whilst it would give companies more information on which to base its choice of auditor, it was unlikely to cause or accelerate an audit tender process or reduce significantly the barriers to switching.[7]

18. Barclays did not have any objection to refining the remit or scope of AQR and believed that greater availability of information would provide an additional tool for both its own AC to assess external auditor performance against and to inform shareholders in their voting decisions at AGMs.[8]

[7] RBS response to the Remedies Notice, 18 March 2013.
[8] Barclays response to the Remedies Notice, 18 March 2013.

19. Berkeley saw value in the AQR communicating better and more frequently the findings of their reviews of audit quality and the benefit of ensuring there was a 'level-playing field' between the Mid Tier and Big 4 in respect of AQR reporting findings.[9]

20. BT Group considered the proposals in the Remedies Notice to have merit but reserved comment on the relative costs and benefits. BT supported transparency in communicating the results and for reports to be clear and detailed in relation to the finding for a particular company.[10]

21. GlaxoSmithKline plc (GSK) did not see the need to increase frequency or scope of AQR reporting but noted that the different review cycles for the Big 4 and other firms was not conducive to opening up the market and questioned if when inspections were delegated to the RSBs if this could be remedied.[11] SAB Miller also did not see the benefit of expanding the role and frequency of AQR and noted that the Big 4 were reviewed annually already.[12]

Case study interviews

22. The CFO of Company K supported expanded frequency and/or remit of AQR subject to not imposing excessive cost and believed once every three years would be appropriate.[13] The ACC of Company K saw no issue with increasing the frequency of AQR.[14]

23. The ACC of Company N saw AQR as an independent check on audit quality and had used the AQR on Company N's audit and the AQR public reports when considering reappointment of the incumbent and also in assessing the quality of firms

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[9] Berkeley Group response to the Remedies Notice, 21 March 2013.
[10] BT Group plc response to the Remedies Notice, 21 March 2013.
[11] GSK response to the Remedies Notice, 25 March 2013.
[12] SAB Miller response to the Remedies Notice, 2 April 2013.
[13] Case Study K, paragraph 15.
[14] Case Study K, paragraph 38.

participating in the tender for the company's audit. The ACC of Company N thought that the frequency of AQR could be linked to tenure.[15] The CFO of Company N had reviewed the AQR's annual reports and considered audit quality in the FTSE 350 to be high, and that the existence of AQR was sufficient incentive to improve quality.

24. The ACC of Company P believed increasing the frequency of review to five years would be beneficial.[16] The GFD of Company R thought that the AQR would need to be upgraded in order to be effective and compared the relative resources employed by the AQR and PCAOB in reviewing the audit of the company.[17] The ACC of Company R considered AQR to have a deterrent effect and suggested increasing frequency to once every five years to match the AEP rotation cycle.[18] The ACC of Company S believed that the system worked 'about right' at present, but was concerned that individual firm reporting would undermine the process.[19] The GFD of Company T believed the existence of the AQR meant that auditors were careful to ensure quality.[20] The ACC of Company T had found AQR to be useful on occasion, though occasionally the points were pedantic but supported an increased frequency and stronger focus on judgements, evidence and documentation.[21] The GFO of Company U thought that any improvement would assist, but a remedy needed to focus on the needs of shareholders.[22] In contrast the ACC of Company U did not see the benefit of developing AQR further. [23]The CFO of Company V did not object in principle to increasing frequency but did not know how they would work in practice.[24] The Chief Accounting Officer of Company W indicated that in his experience audit firms tended to conduct the audit on the basis that it would be reviewed by the AQR

[15] Case Study N, paragraph 40.
[16] Case Study P, paragraph 30.
[17] Case Study R, paragraph 22.
[18] Case Study R, paragraph 38.
[19] Case Study S, paragraph 37.
[20] Case Study T, paragraph 17.
[21] Case Study T, paragraph 34c.
[22] Case Study U, paragraph 11c.
[23] Case Study U, paragraph 30.
[24] Case Study V, paragraph 19.

anyway, so the possibility of more frequent AQR reviews would not change behaviour.[25]

25. Nick Land stated that 'some areas of a company's audit were very visible to the ACC and the AC, others were opaque' and that 'more frequent engagement-level reporting on these areas by the AQR could give some comfort, although Mr Land would like to see more emphasis given to oral examination of the AEP, rather than just scrutiny of the audit files'. Mr Land also supported more frequent reporting on non-Big-4 firms and AC reporting of AQR findings.[26]

Big 4 firms

26. Deloitte noted the significant costs to the FRC (and ultimately the firms) of undertaking a file review. Deloitte noted that the AQR's risk-based and priority sector approach might mean that findings were not necessarily representative of issues across all of a firm's PIE clients. Deloitte suggested the potential to require all FTSE 350 clients to be reviewed over a five-year period, with no specific distinction between FTSE 100 and FTSE 250 audits. It had concerns over the risk that increased granularity would allow certain companies to be identified, particularly where a firm had relatively few FTSE 350 clients. [27]

27. Deloitte noted that there was no consideration of the complexity of a company when assessing the audit quality and further that as the review focused on areas of improvement, could not be seen as a balanced scorecard of audit quality.

28. Deloitte stated that any additional costs could be funded either by an extension of current funding arrangements, companies, or by both companies and firms.

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[25] Case Study W, paragraph 18.
[26] Meeting with Mr Nick Land, paragraphs 11–16.
[27] Deloitte response to the Remedies Notice, 18 March 2013.

29. EY stated that AQR provided a valuable indicator to shareholders and management of FTSE 350 companies of the audit quality of the main audit firms but warned that the potential benefits of an increased frequency of review needed to be offset against the potential costs. EY noted that the FRC could and did respond to published market concerns on particular companies, but suggested that the FRC might wish to consider information for other sources when identifying additional engagements to review.[28]

30. KPMG stated that the current AQR regime 'works well' and that any decision to expand the remit of the AQR needed to be taken by the FRC. KPMG stated that it was not clear if any incremental gain would exceed the additional costs. In KPMG's view there would be a diminishing benefit from each additional company reviewed. KPMG noted that there would be substantial costs incurred by the AQR in increasing the scope or frequency of reviews and that there would also be additional costs to the firms through their most skilled staff participating in the AQR process.[29]

31. PwC supported enhancements to the role of the AQR in aiding the ability of companies to assess the quality of audit firms, but believed the scope of work should be determined by the FRC to maintain its independence. PwC agreed that more regular reviews of individual engagements would provide more frequent insight into a company's audit and would facilitate greater comparison of quality between firms. PwC identified that for the AQR to remain cost-effective any increase in frequency would need to be combined with a streamlining of the process and scope of the reviews, which it felt the FRC was best placed to decide upon subject to consultation of stakeholders. PwC also felt that firms should be required to include more

[28] EY response to the Remedies Notice, 5 April 2013.
[29] KPMG response to the Remedies Notice, 21 March 2013.

information on their own internal quality control processes and outcomes of recent AQR reports in their transparency reports.[30]

Other firms

32. BDO[31] noted that the AQR offered the best current independent assessment of audit quality, but that they were by no means perfect. BDO believed that the reviews had been established to examine audit documentation from a relatively narrow perspective of audit quality, rather than from a more holistic sense in which aspects of service (such as innovation, timeliness and communication) are also taken into account. BDO stated that AQR assessed whether there had been strict adherence to the letter of international auditing standards, but not much more.

33. BDO stated that the AQR needed to revise its approach focusing on key audit judgements and that reviews should be on a five-year cycle with reporting primarily on a company basis. BDO thought that the rebalancing of the reviews towards judgements rather than documentation would be cost-neutral but that any additional costs should be funded under the existing mechanism.

34. Crowe Clark Whitehill (CCW) felt that there was merit in increasing the frequency of reviews to every three years for the FTSE 100 and every five years for the FTSE 250 and systemically risk financial institutions annually. CCW thought that analysis by type of client might be useful, but an alternative would be publishing a comment on whether AQR findings varied significantly between FTSE 350 and other PIEs. CCW supported the need for ACs to report on their understanding of the AQR and key points.[32]

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[30] PwC response to the Remedies Notice, 22 March 2013.
[31] BDO response to the Remedies Notice, 18 March 2013.
[32] CCW response to the Remedies Notice, 18 March 2013.

35. GT[33] was supportive of the introduction of changes to the AQR to enhance the ability to compare firms' respective quality. GT did not believe there needed to be greater frequency of reviews across the board, instead, focusing on firms outside the largest four firms and that all nine major firms should be reported on with equal frequency. GT also stated that the current publication schedule of the Big 4's reports being published at the same time, but other firms separately, could lead to perceptions that the Big 4 were different.

36. GT was concerned that any change leading to the reporting of FTSE 350 quality separately did not lead to the ability to identify individual clients for firms who did not have a large number of FTSE 350 clients. GT felt that the AQR should provide a 'broad comparison of findings from comparable levels of inspection rigor on comparable audits'.

37. Kingston Smith[34] had no particular objection to FTSE 350 results being published separately, but it did not see how this would assist competition, and did not see the benefit of reporting on specific engagements separately. Given the small number of FTSE 350 companies audited by non-Big-4 firms, Kingston Smith was concerned that any indication of poor quality on a single audit might be given undue weight. Kingston Smith felt that any expansion of scope would be 'unduly onerous and time consuming' for both firms and FRC.

[33] GT response to the Remedies Notice, 18 March 2013.
[34] Kingston Smith response to the Remedies Notice, 1 March 2013.

Regulators

FRC[35]

38. In its response to the Remedies Notice, the FRC stated that it agreed that there was scope to consider more frequent AQR inspection but that this was in some cases of higher risk. The FRC also noted the potential for more detailed reporting.

39. The FRC noted that any consideration of audit judgements should only be based on information realistically available at the time. There was a danger of creating a moral hazard problem by causing companies and auditors to follow the previous views of an audit inspection even if circumstances had changed.

ICAEW[36]

40. The ICAEW was supportive of the intent to increase the frequency or scope of AQR reports but did not consider the AQR process to be deficient and that the FRC was best placed to make this decision. The ICAEW noted that whilst greater transparency was desirable, it might have unintended consequences such as increasing firm costs and creating barriers to entry.

41. The ICAEW cautioned against the publication of company-specific findings as there might be greater resistance from firms and findings on subjective matters could be interpreted as more objective shortcomings, damaging the profession and weakening public confidence. The ICAEW felt that it would be better to refer by exception to firms that had fundamentally failed to deliver against standards.

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[35] FRC response to the Remedies Notice, 18 March 2013.
[36] ICAEW response to the Remedies Notice, 21 March 2013.

ICAS[37]

42. ICAS supported the work of the AQR and questioned where the benefit of expanding the remit and or frequency of reporting by the AQR would outweigh the costs.

International

43. The International Federation of Accountants (IFAC) supported a risk-based approach to selection, but a minimum period between reviews should be established. A risk-based approach would necessarily need to factor in a number of indicators, including the size of the audit firm and the types and sizes of entities it audits. IFAC believed that FTSE 350 companies should be considered within the larger population of PIEs and not be treated separately. IFAC noted that the different frequency of reporting on the Big 4 relative to other firms might signal there to be different quality in those firms. Should the AQR need additional resources, as these benefited shareholders, these should be charged to shareholders.[38]

44. The Canadian Public Accountability Board (CPAB) noted that there needed to be an appropriate balance between transparency and the publication of inspection findings and trust and confidence in auditing in the capital markets, such that a regulator could make private impactful recommendations to auditors.[39]

45. The South African Institute of Chartered Accountants (SAICA) recognized the value of AQR but believed increased frequency should be considered against the cost of increasing frequency.[40]

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[37] ICAS response to the Remedies Notice, 18 March 2013.
[38] IFAC response to the Remedies Notice, 18 March 2013.
[39] CPAB response to the Remedies Notice, 18 March 2013.
[40] SAICA response to the Remedies Notice, 20 March 2013.

Others

46. The FD 100 Group was not against increased frequency of AQR but a cost-benefit analysis would need to be performed.[41]

47. One individual with FTSE 350 CFO and ACC experience[42] considered AQR reports to be of limited value to ACs as they were an audit of an audit and were not a review of how effective the audit was. The individual believed that the AQR should begin by interviewing company management and ACs about what they thought of the quality and felt that regulators underestimated the ability of companies to assess audit quality.

[41] The Hundred Group of Finance Directors response to the Remedies Notice, 18 March 2013.
[42] Simon Laffin response to the Remedies Notice, 18 March 2013.

Parties' views on Big 4 only clauses

1. Respondents to our Remedies Notice were almost universally in favour of a prohibition on Big-4-only clauses, in some form. However, they identified no other template documentation as specifically containing a Big-4-only clause.

Investment community

2. The LMA[1] disputed that its template auditor clause limited choice. It said that the clause was not compulsory—the names of the Big 4 firms were in square brackets indicating it might be altered and the clause provided that any other firm might be appointed with majority lender approval.

3. The LMA pointed out that template documentation was designed to promote efficiency by creating a starting point based on market practice. For highly leveraged transactions there was 'an obvious and indisputable need to establish upfront an obligation to apply high quality audit services. To do otherwise would place lenders under unacceptable commercial risk'. Further, its template auditor clause specified potentially acceptable auditors so as to avoid lenders having to engage in the process of agreeing an acceptable auditor in each case, as this would introduce complexity and cost into the lending process.[2] The LMA did not consider there was a need for us to prohibit non-compulsory auditor clauses of the type in its template documentation and there was no compelling evidence to suggest such a prohibition would address the AEC in a meaningful way. Such a prohibition would be inappropriate and disproportionate.[3]

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[1] LMA response to the Remedies Notice, 9 May 2013.
[2] ibid.
[3] ibid.

4. The LMA suggested that an alternative remedy might be to emphasize in template documentation that the selection of a Big 4 firm was not compulsory, or to require that the template clause did not specifically refer to the Big 4 firms by name, but otherwise remained the same. This would enable lenders to specify acceptable names when adopting the template documentation without additional complexity and delay by the parties having to agree the auditor in a separate process.[4] Finally, the LMA urged that careful consideration be given to any form of prohibition so as to avoid market uncertainty and potential disruption.

5. The BBA stated that its member banks did not as a matter of policy stipulate a Big 4 firm. The LMA documentation indicated that lenders and investors should in the first instance consider whether an auditor with a global reach was needed. This, however, was not mandated even in this limited circumstance. The BBA would therefore 'not see any particular reason why the documentation cannot stop short of using the names of the four largest firms to illustrate the point that the auditors used should be of appropriate resource, expertise and geographical reach'. It did not object in principle 'to the optional naming of firms in this way being prohibited', but did not see this having a significant impact.[5]

6. Barclays stated that it did not have a 'systematic policy' as a condition of providing financing that borrowers use a Big 4 firm. However, it did not think it would be 'proportionate or appropriate' to prohibit lenders from ever requiring borrowers to appoint a Big 4 firm if this was appropriate in the particular circumstances.[6]

7. BlackRock supported the proposed prohibition. It stated that such requirements might be anticompetitive and limit the AC's ability to select a non-Big-4 firm with particular

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[4] ibid.
[5] BBA response to the Remedies Notice, 18 March 2013.
[6] Barclays response to the Remedies Notice, 18 March 2013.

industry, business or product expertise. However, it also recognized that some companies might be limited in their choice of audit service providers by the need for global or specialized industry expertise.[7]

8. Hermes stated that it firmly agreed with the ban on Big-4-only clauses and was concerned that this still appeared to be a prevalent issue so long after having been identified by the FRC's work in this respect.[8]

9. L&G was in favour of the remedy as it would remove a barrier to entry for non-Big-4 firms and in combination with other proposals promoted competition.[9]

10. RBS said it did not insist on such clauses and did not object in principle to this remedy.[10]

11. The UK Shareholders' Association supported the remedy[11] as did seven investors and a body representing 56 local authority pension schemes. The eight investors viewed such clauses as anticompetitive.[12]

12. Respondents to our investor questionnaire were broadly in favour of the proposed remedy. [✂] supported the removal of such clauses. [✂] also supported their removal on the basis that they created inappropriate competitive barriers. [✂] also supported their removal on the basis that such clauses were anticompetitive. However, [✂] did not believe it would be a good idea to prohibit Big-4-only clauses in loan documentation: 'The reliability of accounts is very important to investors and

[7] BlackRock response to the Remedies Notice, 18 March 2013.
[8] Hermes response to the Remedies Notice, 18 March 2013.
[9] L&G response to the Remedies Notice, 20 March 2013.
[10] RBS response to the Remedies Notice, 18 March 2013.
[11] UK Shareholders Association response to the Remedies Notice, 20 March 2013.
[12] USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (representing 56 pension funds), London Pensions Fund Authority, Governance for Owners, Environment Agency Active Pension Fund and Sarasin and Partners LLP remedies response, 19 March 2013.

there may be circumstances where, as a lender, we would be more comfortable with one of the larger firms as external auditor.'

Companies (ACCs and FDs)

13. Where FDs and ACCs in our remedies case studies expressed a view they were broadly in favour of a prohibition on Big-4-only clauses. The CFO of Company N, for example, supported removal of Big-4-only clauses as the audit should be open to any firm qualified to undertake it.[13] The ACC of Company P also supported the proposed prohibition but thought it unlikely that this change alone would have a significant impact but it was a sensible thing to do.[14]

14. BT, in responding to the Remedies Notice, supported the proposed remedy because it considered that it should be the company's decision as to who to appoint as auditor.[15]

15. The Hundred Group Finance Directors (Investor Relations and Markets Committee) did not oppose the remedy but stated that ultimately it was at the discretion of lenders as to whether they would oppose use of non-Big-4 firms.[16]

FRC and other regulators

16. The FRC supported a ban on such clauses in loan and 'other banking agreements'.[17] The FRC added that it did not believe that Big-4-only clauses should form part of standard loan or contract documentation. However, it would not seek to impede the ability of investors to specify that they would accept certain auditors as long as this

[13] Case Study N paragraph 19.
[14] Case Study P, paragraph 31; see also, for example, Company R, paragraph 39; Company T, paragraph 34; and Company V, paragraph 20.
[15] BT response to the Remedies Notice, 21 March 2013.
[16] The Hundred Group of Finance Directors response to the Remedies Notice, 18 March 2013.
[17] FRC response to the Remedies Notice, 18 March 2013.

was a considered decision as opposed to a default position contained in advisers' standard documentation.

17. The ICAEW supported the measure but pointed out that such clauses could be in a wide range of individually drawn-up contracts, not just LMA lending agreements. In particular, tender documents, if 'drawn too tightly in their requirements are as effective as the Big 4 only clauses in limiting competition, merely by replacing names with attributes'. In its view, whether the abolition of such clauses would have any practical effect would depend on recognition that quality existed outside the major firms.[18]

18. The CFA Society of the UK supported the prohibition in all documentation. The main benefit would be to open up tenders to more firms and would not add to costs. The clause would open up the market to non-Big-4 firms but might not be enough to encourage them to compete for larger company audits.[19]

The Big 4 firms

19. The Big 4 firms broadly supported the proposed measure.

20. Deloitte considered that the effect of this remedy was likely to be very limited as the instances of clauses limiting choice of auditor in the reference market were very limited. However, Deloitte agreed that, to the extent that FTSE 350 companies were constrained, this remedy would be effective in increasing companies' willingness to switch auditor by increasing the pool of permitted choices and would be effective in reducing barriers to entry.[20]

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[18] ICAEW response to the Remedies Notice 21 March 2013, Appendix, paragraphs A19–A21.
[19] CFA Society of the UK response to the Remedies Notice, 14 March 2013.
[20] Deloitte response to the Remedies Notice, 18 March 2013, paragraphs 6.1 & 6.2.

21. EY stated that it was fully supportive of proposals to prohibit clauses in loan documentation which limited auditor choice to Big 4 firms. EY suggested that we consider whether the prohibition should be extended to banks' own standard forms, as in terms of influence on market practice these may be as influential as the LMA's template, and to bilateral agreements.[21]

22. KPMG thought that these clauses were not a significant determinant in the choice of audit firms and pointed out that we did not believe this remedy in itself would have a substantial impact. It would support the removal of such clauses if deemed to adversely affect competition but it pointed out that lenders might have particular requirements and genuine commercial needs which should be recognized.[22]

23. PwC stated that to the extent that the existence of such clauses prevented Mid Tier firms being appointed or reinforced a perception that they were unable to compete in the market, it supported removal of such clauses and believed it would allow all firms to demonstrate their credentials in a tender process.[23]

Non-Big-4 audit firms

24. Non-Big-4 firms also supported the measure.

25. BDO believed that the remedy should go wider than the LMA template. It should encompass all such contractual clauses, whether in loan documentation or otherwise and should not be confined to the reference market but all companies.[24] Furthermore, any prohibition should extend to clauses which had the same effect as a Big-4-only clause (in its opinion, by for example requiring lender approval) or any conduct which might reasonably be taken to have the same effect as a Big 4 only

[21] EY response to the Remedies Notice, Annex 2, paragraphs 5.1–5.3.
[22] KPMG response to the Remedies Notice, 21 March 2013, paragraph 6.2.
[23] PwC response to the Remedies Notice, paragraph 3.49.
[24] BDO response to the Remedies Notice, paragraph 4.3.

clause[25] because the 'real battle for FTSE 350 clients' takes place before companies enter that market.[26]

26. BDO believed that these clauses were quite often used in a 'thoughtless way, where because it has been there forever and that prejudice has been there forever, it is just the norm'.

27. CCW stated that it supported the prohibition of any anticompetitive contractual clause. The remedy would encourage wider choice and potentially reduce costs in the provision of services. The wider benefit would be to expand the exposure and experience companies had of non-Big-4 firms which could over time lead to gaining greater confidence and assurance in their abilities.[27]

28. GT supported this proposal as such clauses represented a reputational barrier and restricted choice, but recognized that there might be instances where lenders could legitimately restrict the choice of a professional service provider. GT believed the proposed remedy helped create a level playing field so that auditor selection was free from bias and informed by auditor quality and capability. GT believed that these clauses existed in 'unwritten form' and in agreements wider than template leveraged loan documentation. It therefore submitted that we should prohibit all forms of third party anticompetitive restrictions, written or otherwise, on choice of auditor. The prohibition should extend to clauses which had the same effect as a Big-4-only clause—for example, in its opinion, references to a 'reputable' auditor could be taken to mean a Big 4 firm only. The removal of such clauses would, in GT's view, remove

[25] ibid, paragraph 4.5.
[26] Summary of remedies response hearing held with BDO on 10 April 2013, paragraph 7.
[27] CCW response to the Remedies Notice, 18 March 2013.

direct constraints on companies' abilities to choose an auditor outside of the Big 4 firms and over time would materially assist in reducing reputational barriers.[28]

29. Kingston Smith supported this remedy or the prohibition of any size restriction clause but believed it should be widened to cover any document which included such a prohibition, for example a company's governing documents. It noted that this would not, however, eliminate 'verbal encouragement' to appoint a Big 4 firm.[29]

[28] GT response to the Remedies Notice, 18 March 2013, Appendix, paragraph 3.
[29] Kingston Smith response to the Remedies Notice, 1 March 2013, Section 4.

Parties' views: enhanced shareholder engagement

1. Parties were asked to comment on the four options suggested by the CC to enhance shareholder-auditor engagement as set out in the Remedies Notice.

Investors

2. Most investor questionnaire respondents were supportive of the general principle of increasing shareholder-auditor engagement. However, the vast majority of them either opposed the tender voting remedy and enhanced voting remedy or had no view on the remedies' likely effectiveness.

3. There was also a degree of scepticism as to whether the AEP presentation remedy and ACC Q&A remedy would be effective. The concerns raised were as follows:
   (a) The AGM was not an appropriate place for an extended discussion on audit because of limited shareholder attendance.
   (b) A large number of AGMs occurred within the same short period of time and investors were therefore restricted by time and availability when choosing which AGMs to attend; attendance was only a priority where there was a matter of interest or controversy on the agenda at the AGM. However, it was recognized that a requirement for companies to use modern technology, which would allow for electronic attendance at AGMs (eg webcast), would help reduce this difficulty.
   (c) It would be difficult to circulate disclosure on audit issues to shareholders in advance of the AGM, but it would be beneficial to do so; improved auditor reports and/or 'investor days/forums' may be more effective in addressing any information gap.

Companies

4. The CFOs and ACCs participating in the recent case studies were also asked for their views on the remedy. Their general view was that the level of shareholder interest in the audit was slight unless there was a crisis (although a couple, the ACCs of Companies P[1] and T,[2] thought the remedy had some merit in principle). The ACC of Company S, for example, commented that 'in many years as a Finance Director in the past, the ACC had never been asked any question by a shareholder about the accounts'[3]; the ACC of Company W noted that very few institutional shareholders attended the AGM and that such meetings were not generally occasions where constructive debate took place.[4] The CFO of Company M similarly said that 'enhanced shareholder-auditor engagement' ignored the reality that some 20 people turned out for his company's AGM. These were generally small shareholders and retired people, and there was no discussion of resolutions before they were voted through.[5]

5. Nick Land, the ACC of four multinational companies, also noted that institutional shareholders used proxy agencies to exercise votes in all but their largest holdings and engagement with proxy agencies had been difficult. He also suggested that a significant proportion (perhaps 40 per cent) of FTSE 350 shares were held by overseas entities and individuals, making investor engagement even more difficult.[6] The ACC of Company K suggested that that there was a general lack of shareholder engagement because shareholders often only held shares in the short term and did not have a long-term interest in the success of the relevant company. This was in

[1] Case Study P, paragraph 33.
[2] Case Study T, paragraph 34(f).
[3] Case Study S, paragraph 39.
[4] Case Study W, paragraph 22.
[5] Case Study M, paragraph 11(e).
[6] Note of meeting with Mr Nick Land, paragraph 26.

part due to the emergence of 'index traffic' where shareholders did not choose the shares they bought but held them as part of an index investment.[7]

6. The GC100 (representing General Counsel and company secretaries of the FTSE 100) opposed this remedy. Its key points were the following:[8]

   (a) Tender voting remedy: Shareholders appointed board members, delegating them authority to run the company; this included deciding when best to tender.

   (b) Enhanced voting remedy: It was not appropriate to have an enhanced majority for the reappointment of an auditor following a tender because only a simple majority was required to appoint a director.

   (c) AEP presentation remedy: The GC100 saw little merit in asking AEPs to present at the AGM. Auditors were already present and could answer any (in practice rare) questions. It would also unnecessarily extend the AGM.

   (d) ACC Q&A remedy: Shareholders already had the right to raise questions.

Regulators

FRC[9]

7. The FRC welcomed the principle of enhanced shareholder-auditor engagement. However, it pointed out that similar proposals included in the FRC's 2011 *Effective Company Stewardship* consultation received a largely negative response from investors and other market participants. The FRC pointed out that we should not rely upon significant time commitment from investors.

8. The FRC considered that the AEP presentation remedy and ACC Q&A remedy struck the right balance.

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[7] Case Study K, paragraph 40.
[8] GC100 response to the Remedies Notice, response 6.
[9] FRC response to the Remedies Notice, section 6.

ICAEW[10]

9. The ICAEW considered that enhancing shareholder-auditor engagement must be done with caution so as to not prejudice any one shareholder.[11] It considered that this would be an issue best referred to the FRC to be dealt with under corporate governance rules.[12]

10. The ICAEW did not support requiring auditor reappointment to be approved by an enhanced level of shareholder votes; for the will of a simple majority not to be allowed to prevail in such a matter significantly undermined majority rights. In its view, such requirements should be for fundamental issues of the corporate constitution.[13]

The Big 4 firms

Deloitte[14]

11. Deloitte was broadly supportive of initiatives to increase shareholder-auditor engagement. It responded as follows on our specific proposals:

12. *Tender voting remedy*: It supported this proposal where shareholders had sufficient information to vote on an informed basis. Deloitte suggested that enhanced AQR reports (Remedy 3) could plug any information gaps.

13. *Enhanced voting remedy*: Deloitte rejected this proposal on the basis that the existing majority basis was sufficient.

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[10] ICAEW response to the Remedies Notice, Appendix, Section 6.
[11] ibid, paragraphs A27–28.
[12] ibid, paragraph A29.
[13] ibid, paragraph A30.
[14] Deloitte response to the Remedies Notice, paragraphs 8.1–8.6.

14. *AEP presentation remedy*: Deloitte pointed out that there were a number of practical and liability-related considerations that would need to be addressed before implementing such a remedy:

(a) There would need to be a defined boundary between the AEP providing information about the audit process and providing company information best provided by other persons.

(b) Moving auditors' reporting into a freeform discussion posed a clear threat to audit quality, as it removed a series of layers of quality assurance, challenge and review that was associated with the current written report.

(c) Such an approach raised questions of transparency, since it would appear to favour those present at the meeting, rather than all shareholder (or even stakeholder) recipients of a formal written report.

(d) The liability-related issues included the liability of the auditor in relation to providing information outside of an audit report and the responsibility of the auditor to individual shareholders compared with the shareholder body as a whole. Ambiguity around liability would risk tipping the process into one whereby the AEP simply read aloud the auditor's report, which was likely to serve as little more than a formality rather than adding any value.

15. *ACC Q&A Remedy*: Deloitte agreed that this could be broadly effective, subject to the practical and liability issues set out in point (c) above.

16. Deloitte did not consider that the costs of the proposed remedies would be high and that most of the suggestions could be accomplished without material cost to companies or to audit firms.

EY[15]

17. EY supported of each of our proposals to improve shareholder-auditor engagement. EY noted that the requirement for AEPs to present at AGMs was already a requirement in other jurisdictions. However, EY stated that for the presentations to be effective there needed to be clear guidance on the appropriate and required content of such a report.

KPMG[16]

18. KPMG considered that increased reporting should not require the audit firm to offer subjective opinions which would run the risk of substituting management's judgement with that of the audit firm in preparing financial statements. KPMG also noted that it was not the role of the audit firm to disclose commercial information—this was the prerogative of the board.

PwC

19. PwC objected to giving shareholders the right to vote for a tender and enhancing the voting requirement for reappointment of an auditor to greater than a simple majority. Its principal reasoning was: *(a)* shareholders did not have the benefit of participating in the tender process; *(b)* minority shareholders could become overly empowered due to low voter turnout; and *(c)* it was inappropriate to accord the appointment of the auditor the same magnitude of importance as winding up the company (for example).[17]

20. PwC broadly supported the AEP presentation remedy and the ACC Q&A remedy because these enabled shareholders to make their views known on auditor selection

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[15] EY response to the Remedies Notice, Annex 2, paragraphs 7.1–7.4.
[16] KPMG response to the Remedies Notice, paragraph 8.2.
[17] PwC response to the Remedies Notice, Annex 3, paragraph 40(c).

(if the company announced a tender) and the conduct of the auditor. It flagged two possible issues with regard to the AEP presenting at the AGM:[18]

(a) The letter of engagement would need to be re-drafted to ensure that auditors did not breach their duty of confidentiality at the AGM.

(b) The auditor needed to be careful to ensure that it did not extend the auditor's duty of care beyond that currently given.

21. PwC considered that the cost of auditor and ACC attendance at the AGM was likely to be limited.[19]

Other firms

BDO[20]

22. BDO was in favour of this remedy and stated its understanding that Oxera had found that larger investors would like more transparency and disclosure.

23. BDO stated that costs would be confined to extra work for ACCs and auditors, particularly AEPs. BDO did not consider that these would be extensive or dis-proportionate.

GT

24. GT supported the principle of enhanced shareholder-auditor engagement and broadly supported the AEP presentation remedy and ACC Q&A remedy.[21]

25. GT opposed the tender voting remedy and enhanced voting remedy.[22]

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[18] ibid, paragraph 41.
[19] ibid, paragraph 43.
[20] BDO response to the Remedies Notice, paragraphs 6.2 & 6.3.
[21] GT response to the Remedies Notice, paragraph 5.3.
[22] ibid, paragraph 5.4.

26. GT thought that improved information flow would be better served through improved reporting in the AC or auditor's reports to meet the demands of investors. Investors had indicated for a long time that they desired enhanced auditor reporting.[23]

27. GT considered that enhanced reporting was an issue to be dealt with by national or EU standard setters and that there was unlikely to be a role for the CC in implementing direct measures.[24]

Kingston Smith[25]

28. Kingston Smith considered that shareholder-auditor engagement was best achieved by increased communication and dialogue with the AC. It did not support the options set out in the Remedies Notice.

Mazars

29. Mazars was supportive of the principle of this remedy. It had developed a 'Centre for Audit Committee and Investor Dialogue', a platform for ACCs and investors to discuss current issues. It had held three events in the last 18 months focusing on market issues.

[23] Ibid, paragraph 6.1.
[24] Ibid, paragraph 6.3.
[25] Kingston Smith response to the Remedies Notice, Section 6.

Parties' views: strengthening the accountability of the external auditor to the audit committee

1. Most of the 56 submissions received in response to the provisional findings and Remedies Notice gave a view on this proposed remedy. Some of the main parties elaborated on these views in the response hearings with the Inquiry Group. In addition, the FDs and ACCs of 14 listed UK companies, to whom we spoke in a series of case studies following publication of the provisional findings, had the opportunity to respond to the proposed remedy.

2. Investor groups[1] strongly supported the proposed remedy. The NAPF agreed that the role of the AC was crucial in overseeing the audit process on behalf of shareholders and that the AC ought to be robustly independent of management and have the appropriate skills in order to be able effectively to monitor the auditor's independence and objectivity and the effectiveness of the audit process and that it should also seek to be open and accountable to the shareholders.[2] Accountancy institutes and analysts took a similar view:[3] the CFA Society of the UK, for example, stated that the direct line of communication between the auditor and the FD was too strong.[4]

3. In its written submission, the FRC recalled that recent changes to its Corporate Governance Code had been designed to avoid the risk that issues were resolved between the FD and the auditors without reference to the AC. The Code now required that the auditor report more matters to the AC, and that the AC extend the

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[1] USS Investment Management, RPMI Railpen, National employment Savings Trust (NEST), Local Authority Pension Fund Forum (on behalf of 56 pension funds), London Pensions Fund Authority, Governance for Owners and Environmental Agency Active Pension Fund, Hermes Equity Ownership Services, Kames Capital, UK Shareholders' Association, Legal & General Investment Management, BlackRock, National Association of Pension Funds: see www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/responses-to-provisional-findings-report-and-notice-of-possible-remedies.
[2] See NAPF response to the provisional findings and Remedies Notice.
[3] CFA Society of the UK, the Chartered Institute of Management Accountants, Chartered Professional Accountants, International Federation of Accountants (see www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/responses-to-provisional-findings-report-and-notice-of-possible-remedies).
[4] CFA Society of the UK response to the Remedies Notice.

range and scope of its report to shareholders about its oversight of the external auditor, including reporting the issues that had arisen during the audit and explanations of how these had been resolved.[5]

4. In their submissions, eight leading companies argued that the current arrangements worked well and that no additional powers or enhanced accountability were needed.[6] The GC100, representing general counsel and company secretaries in the FTSE 100, stated that a responsible ACC was actively involved in the relationship with the external auditor, and that the revisions to the FRC's Corporate Governance Code should be allowed time to take effect before introducing any further remedies.[7] The representatives of 17 companies we interviewed at FD or ACC level (published as case studies) uniformly took the same view.[8]

5. Most of the other respondents to the Remedies Notice, however, including the Big 4 firms, accepted the principle of strengthening the role of the AC.

6. PwC agreed that the AC should be promoted and reinforced as being responsible for managing the tender process and the relationship with the auditor noting that further strengthening the role of the AC—albeit with care to avoid unintended detrimental consequences—was critical.[9] KPMG supported measures to improve reporting by audit firms to ACs and to ensure they became standard practice.[10] Although considering that we had undervalued the power and influence of ACs, and in particular ACCs, EY conceded that a requirement that certain aspects of the relationship with the audit firm had to be carried out by the ACC rather than the FD could be made

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[5] FRC response to the provisional findings and Remedies Notice.
[6] Aggreko, Berkeley Group, Billiton, SABMiller, Glaxo, Segro, Smith & Nephew, BT (see www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/responses-to-provisional-findings-report-and-notice-of-possible-remedies).
[7] GC100 response to the provisional findings and Remedies Notice.
[8] Details of the 17 case studies (companies G-W) are available on the CC website
[9] PwC response to the provisional findings and Remedies Notice, paragraphs 3.9 and 3.50–3.52.
[10] KPMG response to the Remedies Notice, paragraph 7.1.

more explicit.[11] Deloitte supported measures that enhanced the responsibility of ACs to shareholders.[12]

7. GT considered that, in making the audit firm more independent of management, the remedy would help to facilitate greater competition in the market (by providing a platform for greater independent review of the performance of audit firms).[13] BDO welcomed the proposal that the price and scope of an audit should be negotiated with the ACC because at present FDs were believed to play the leading role in the choice of auditors.[14] Some, but not all, of the Mid Tier audit firms were generally supportive of all the proposed remedies but considered them insufficient as a package.[15]

Main criticisms of the proposed remedy

8. Despite accepting the principle of strengthening the AC, many respondents argued that the full remedy, as specified in the Remedies Notice, was in some respects impractical. It could also undermine the tripartite system (between AEP, FD and AC) and blur the distinction between executive and non-executive functions in a company.

9. The aspects of the remedy that met most criticism were:

   (a) *Making the AC responsible for the full gamut of engagement management issues with the auditors:* This would, according to Deloitte, be disproportionate and unwieldy.[16] BT said it was inappropriate to suggest that executive management should not take responsibility for decision-making within the business.[17]

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[11] EY response to the provisional findings and Remedies Notice, Annex 2, paragraph 6.5.
[12] Deloitte response to the Remedies Notice, paragraphs 7.1 & 7.2.
[13] GT response to the Remedies Notice, Appendix, paragraphs 4.1–4.3.
[14] BDO response to the Remedies Notice, paragraph 5.2.
[15] Responses were received from Mazars, Kingston Smith, CCW and Baker Tilly on behalf of the Mid Tier firms (see www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/responses-to-provisional-findings-report-and-notice-of-possible-remedies).
[16] Deloitte response to the Remedies Notice, paragraph 7.5.
[17] BT Group response to the Remedies Notice.

(b) *Making the AC the first point of contact if a material issue arises:*

(i) Several respondents (including the FRC[18]) argued that, in practice, the FD would have to be heavily involved. KPMG stated that the preparation of the financial statements was in the first instance the FD's responsibility and that it was inevitable therefore that there would be a dialogue with the FD to establish the facts and assumptions involved since without such discussion it would not be known with any certainty as to whether there was or was not a 'material audit issue' needing to be resolved.[19]

(ii) Critics also argued that this aspect of the proposed remedy could lead to inefficiencies. PwC, for example, wrote that the CC should be wary of the unintended consequences of preventing the auditor making all necessary enquiries of the FD and finance team and that such a stipulation might well impair the auditor's ability to obtain or even demand access to the full information from the FD and could greatly increase the time commitment required of AC members without significantly increasing their effectiveness.[20]

(iii) The FRC, similarly, wrote that the auditors must not lose sight of their responsibility to report to shareholders if they remained concerned that matters had not been adequately resolved by action of the AC.[21]

(c) *The issue of executive responsibility:* More generally, the above two proposals *(a)* and *(b)* were seen by many as potentially taking the AC into an executive management role and to negate the benefit of the ACC being in an independent and adjudicative role.[22] The CBI, for example, considered that the conclusions drawn on the role of AC and their Chairs blurred the distinction between the role of management and non-executive directors in relation to audits.[23] The FRC said that it would want to explore whether the non-executives would be able to

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[18] FRC response to the provisional findings and Remedies Notice.
[19] KPMG response to the Remedies Notice, paragraph 7.4.
[20] PwC response to the provisional findings and Remedies Notice, paragraph 3.54.
[21] FRC response to the provisional findings and Remedies Notice.
[22] For example, EY response to the provisional findings and Remedies Notice, Annex 2, paragraph 6.7.
[23] CBI response to the provisional findings and Remedies Notice.

discharge this responsibility and whether the proposals as written threatened the principle of collective board responsibility.[24]

More acceptable elements or variants

10. Some aspects of the proposed remedy attracted more widespread support. Some respondents also put forward variants of those aspects with which they had not agreed in a form they considered more acceptable. Elements of a remedies package that many respondents would accept as proportionate and effective included:

(a) The AC to be formally responsible for approving all decisions made in relation to auditor engagement management (eg as proposed by Deloitte). This would enable the three-way dialogue between management, auditors and the AC to be maintained. It would also ensure that management and shareholders understood that the AC was primarily responsible for the appointment and oversight of the auditor.[25]

(b) The ACC could directly negotiate the scope of the audit and fee for the auditor (EY would, for example, support the AC taking responsibility for negotiating audit fees from the FD[26]). However, this proposal was not generally well received by the FDs and ACCs interviewed as part of the CC's case studies on the grounds that ACCs could not be expected to have adequate in-depth knowledge of a company. Only one FD (of Company O) saw value in this since it would demonstrate that the AC was fully in the lead in running the relationship with auditors.[27] The ACC of Company M questioned if the negotiation of fees by the ACC would bring any gain.[28] The ACC of company U questioned the ability for the ACC to negotiate independently because they would have to rely heavily on input from the executive.[29]

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[24] FRC response to the provisional findings and Remedies Notice.
[25] Deloitte response to the Remedies Notice, paragraph 7.5(a).
[26] EY response to the provisional findings and Remedies Notice, Annex 2, paragraph 6.9.
[27] Company O, paragraph 9
[28] Company M, paragraph 29 (c)
[29] Company U, paragraph 30

(c) The AC could also be given responsibility for when to tender and rotate the tender process and auditor appointment (as supported by, for example, GT[30]).

(d) All material audit issues to be reported to the AC, including details of how they were resolved. More radically, as proposed by PwC, all material issues to be escalated to the AC for a final decision, when the auditor was fully informed of the facts necessary to form a judgement.[31] In similar vein, CCW proposed that the AC should be enhanced by ensuring they attended any clearance meeting with executive management of discussions with them over material audit issues. Further, auditing standards should be amended to require the AEP to monitor whether the ACC had been informed of all such meetings—and also to ensure the ACC saw all relevant papers.[32]

Method of implementation

11. Respondents generally considered that any changes could be achieved by building on the current guidance on the role of the AC. GT, for example, thought this could be achieved without materially changing the legal duties of the directors and the board of the company.[33] Deloitte considered that the remedy could be implemented by recommending to the FRC that its Guidance for ACs be amended; alternatively, it could be implemented by recommending to the FRC that it amend the existing provisions of the Corporate Governance Code; this would then be subject to the 'comply or explain' regime.[34] PwC also suggested that some aspects of the remedy could be implemented through enhancements to ISA (UK&I) 260 in combination with the FRC issuing suitable guidance to ACs to support the operation of the Code.[35]

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[30] GT response to the Remedies Notice, Appendix, paragraphs 4.4 & 4.5.
[31] PwC response to the provisional findings and Remedies Notice, paragraph 3.56.
[32] CCW response to the Remedies Notice.
[33] GT response to the Remedies Notice, Appendix, paragraph 4.6.
[34] Deloitte response to the Remedies Notice, paragraph 7.7.
[35] PwC response to the provisional findings and Remedies Notice, paragraph 3.53.

Costs of the remedy

12. Respondents generally agreed with our assessment that the remedy would involve direct costs in terms of the additional time commitment required of AC members (particularly when coupled with the FRC's new provisions on fuller AC reports. These were generally thought to be sustainable ('evolutionary rather than seismic', according to GT[36]).

13. A few respondents (including Kingston Smith[37] and Deloitte[38]) suggested that the role of the ACC might also become less attractive as a result of the increased time commitment involved, and the pool of suitably qualified persons willing to take on the role might be diminished. Some ACCs of the case study companies[39] interviewed by the CC took this view, one (of Company L)[40] argued that the ACC was a growing job, with a real downside to it; careful thought had to be given to adding to its workload by increasing reporting requirements and giving it new functions; such changes would make the ACC role more fraught with risk and would affect the willingness of people to take on the task.

[36] GT response to the Remedies Notice, Appendix, paragraph 4.10.
[37] Kingston Smith response to provisional findings and Remedies Notice.
[38] Deloitte response to the Remedies Notice, paragraph 7.6(b).
[39] See www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/case-studies.
[40] Company L, paragraph 29.

Extended reporting

1. All of the views expressed below were received by the CC prior to the June 2013 revision of ISA 700, but after the publication of the FRC's February 2013 exposure draft, which was implemented with some minor amendments.

Companies

2. BHP Billiton noted the ongoing European proposals on audit reform and uncertainty about outcomes, and suggested we should consider the impact of the FRC's work on 'Effective Company Stewardship'.[1]

3. RBS noted the FRC code on enhanced AC reporting and stated that the needs of the lay reader of financial statements should not be overlooked in any extended audit reporting.[2]

4. Barclays did not consider the remedy to be an effective method of addressing the AEC and stated that an audit report should provide shareholders with a succinct statement of comfort in relation to the truth and fairness of the financial statements. Barclays felt that any increase in the length of the audit report could potentially make auditors more conservative. It did not identify with the provisional findings that management was reluctant to make greater disclosure and recommended additional reporting on control or audit-related matters should be a requirement.[3]

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[1] BHP Billiton response to the Remedies Notice, 15 March 2013.
[2] RBS response to the Remedies Notice, 18 March 2013.
[3] Barclays response to the Remedies Notice, 18 March 2013.

5. Aggreko supported greater discussion in the annual report about the AC's engagement with auditors.[4]

6. BT Group supported the FRC's focus on 'cutting clutter' and noted the FRC's work on improving the AC report and did not support further disclosure.[5]

7. GSK saw no need to extend reporting requirements further and noted that additional disclosure ran against the trend of 'cutting the clutter'.[6]

8. Rexam welcomed changes that 'comment on audit control effectiveness or audit process efficiency' but did not believe that 'additional commentary on methodology or detailed testing undertaken by the auditors would add value and indeed may serve to mask the reporting of issues'.[7]

Case study interviews

9. The CFO of Company K did not think that the auditor's statement should 'add value'—it was the threat that the auditor might add a qualification to the report that was important.[8] The CFO of Company L encouraged reinforcing existing self-regulation mechanisms rather than creating new reporting requirements.[9] The ACC of Company L said that any further responsibilities placed on an AC, such as additional reporting requirements, would be difficult and detract from the AC's bandwidth[10] and that careful thought had to be given to any addition to its workload by increasing reporting requirements.[11] The CFO of Company M thought that audit reports were getting too long and detailed, but there was scope for putting more into

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[4] Aggreko response to the Remedies Notice, 20 March 2013.
[5] BT Group response to the Remedies Notice, 21 March 2013.
[6] GSK response to the Remedies Notice, 25 March 2013.
[7] Rexam response to the Remedies Notice, 26 March 2013.
[8] Case Study K, paragraph 18.
[9] Case Study L, paragraph 13.
[10] ibid, paragraph 28.
[11] ibid, paragraph 29.

reports of the ACC.[12] The ACC of Company M stated that it was uncertain how changes in the level of disclosure had changed the level of the engagement of external stakeholders.[13]

10. The CFO of Company N said that any extended reporting requirements should be included in management reports, such as the Audit Committee Report.[14] The ACC of Company N saw no benefit in requiring more reporting by companies but saw some merit in extended reporting by audit firms.[15]

11. The ACC of Company Q stated extended reporting requirements would not be problematic but it would be important to avoid insubstantial, 'boiler-plate' reports for the sake of form.[16] The ACC of Company R said that some issues that could be included in extended auditor reporting (such as key issues during the audit, decisions on certain accounting judgements) were included in part already in the accounts. The ACC had a concern that any additional reporting would likely be closely monitored by legal advisers and would trend towards a standard format. This would lessen its value to shareholders.[17]

12. Whilst the FD of Company S considered that the current audit report was very binary and did not provide any real information, there were risks that greater reporting might not be very useful for investors. In his view, only a very small number of equity market participants read annual reports. There was lots of other information available to investors and many investors tended to focus on information that was not actually audited (ie preliminary announcements). The FD considered that making the AC

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[12] ibid, paragraph 11(f).
[13] ibid, paragraph 29(e).
[14] Case Study N, paragraph 20.
[15] ibid, paragraph 40.
[16] Case Study Q, paragraph 18.
[17] Case Study R, paragraph 41.

report more interesting for investors was difficult without disclosing commercially sensitive information.[18]

13. The ACC of Company T had no issue with an enhanced reporting remedy and noted that some changes in this area [were] in train. He considered that it would be helpful to include in reports more disclosure as to how particular accounting treatments had been decided on.[19]

14. The GFD of Company U said that a sensible and robust framework already existed for disclosure and any changes should be taken forward within that framework. The GFD questioned that having another report by the auditor would enhance competition. The cost of compliance would grow steadily, strengthening the Big 4 audit firms and hindering competition. It was the companies, not the audit firms, that should make all disclosures.[20]

15. The CFO of Company V did not think that extended reporting would add any value in practice.[21]

16. Mr Nick Land said that at the moment the audit report was binary and in most instances was not worth reading. Investors therefore did not have a 'hook' on which they could ask questions about the auditor or the audit. One way of facilitating engagement would be to expand the audit report. Depending on the way investors reacted to such moves, further measures might be devised to build on them.[22]

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[18] Case Study S, paragraph 18.
[19] Case Study T, paragraph 34(g).
[20] Case Study U, paragraph 11(g).
[21] Case Study V, paragraph 23.
[22] Note of a meeting with Mr Nick Land, paragraph 25.

Big 4 firms

17. Deloitte was supportive of enhanced reporting to shareholders and believed it would be effective and proportionate. Deloitte stated that any remedy by the CC should be consistent and not duplicative of the ongoing reforms by other entities. Deloitte agreed that enhanced reporting would give shareholders better information to better exercise their right, but whilst sceptical that barriers to switching were high believed the remedy would be effective in increasing the visibility of audit quality. Deloitte noted that the IAASB's proposals were broader than the FRC's, looking at the audit quality framework as a whole in addition to AC and auditor reporting. Given the work of the FRC and IAASB, Deloitte did not think it necessary for the CC to impose changes, other than perhaps a backstop remedy. Deloitte believed that any change to reporting requirements should be at a high level to avoid boiler plating.[23]

18. EY was in the process of responding to the FRC consultation but noted its previous response to the FRC's consultation on tendering, and proposed that an expanded 'auditor effectiveness and independence assessment' should be reported on at least every three years.[24,25]

19. KPMG stated that the ability to meet unmet investor demand (to the extent that it existed) could not be solved by individual firms acting unilaterally and it acknowledged that there needed to be consensus and regulation. KPMG supported the ongoing work of the FRC, but warned of the danger of making public all AC-auditor conversations.[26]

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[23] Deloitte response to the Remedies Notice, 18 March 2013.
[24] EY response to the Remedies Notice, 19 March 2013.
[25] www.ey.com/Publication/vwLUAssets/EY-Response-to-FRC-tendering-April-12/$FILE/EY-Response-to-FRC-tendering-April-12.pdf.
[26] KPMG response to the Remedies Notice, 21 March 2013.

20. PwC stated support for extended reporting requirements to address unmet demand. It noted the importance of international consensus on audit reporting, which would be achieved by the IAASB consultation. PwC considered both the FRC and IAASB to be conducting robust processes capturing all stakeholders' views. It did not feel further action was required beyond that being undertaken by the FRC and the IAASB. PwC referred to responses to previous IAASB consultations that 'reconfirmed the fundamental principle that the auditor should not be the original source of factual data or information about the entity' to avoid blurring the respective responsibilities of the auditors and the directors. PwC considered the costs of improving reporting to be small.[27]

Other firms

21. BDO considered the FRC's proposals on auditor and AC reporting to be 'broadly appropriate'. It agreed that the remedy would address the AEC by overcoming the reluctance of management to permit further disclosure of information about the audit process, providing shareholders more information of audit quality to exercise their rights at AGMs and increase the visibility of audit quality, giving companies an opportunity to appraise the quality of other firms. BDO noted Oxera's work with large investors that most would like more transparency and disclosure.[28]

22. CCW noted and supported the work of the FRC and IAASB on extended reporting but stated that any proposals needed to address concerns of institutional investors and shareholder groups.[29] CCW perceived the benefits of extended reporting to be clearer and more effective communication of the audit process and the degree of rigour and challenge that was present therein. CCW stated that the auditors' report should not contain information not included in the directors' report.

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[27] PwC response to the Remedies Notice, 22 March 2013.
[28] BDO response to the Remedies Notice, 18 March 2013.
[29] CCW response to the Remedies Notice, 18 March 2013.

23. GT supported efforts to improve AC and auditor reporting and agreed with the CC that the FRC was best placed to address the issue with companies and shareholders. GT noted that auditors could be required to provide assurance that the AC report was consistent with the auditor's understanding of a company's policies. Furthermore, GT stated that the respective responsibilities of directors (reporting on accounting) and auditors (reporting on audit) should remain intact. GT saw the benefits of improving transparency over how companies engaged with the auditor and ensure that the auditor was independent and reduce any misalignment of incentives.[30]

24. GT suggested that companies should disclose their policy on using firms other than the incumbent for non-audit work and for using more than one firm in the group audit. GT believed that these would break down barriers in the market.

25. Kingston Smith was not in favour of any expansion to the audit report, such as the disclosure of materiality or key audit risks, as proposed by the FRC, as this increased the risk to the auditor to a level which was unacceptable and was likely to be counter-productive to competition. It believed that the appropriate solution was improved communication between shareholders and the AC, with the audit report serving its existing purpose of stating if the financial statements were true and fair. Kingston Smith was concerned with the suggestion that the auditor should comment on a company's interpretation of accounting standards and that there was no need for this, as this was covered by the true and fair opinion.[31]

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[30] GT response to the Remedies Notice, 25 March 2013.
[31] Kingston Smith response to the provisional findings and Remedies Notice, 1 March 2013.

Regulators and accountancy bodies

FRC

26. The FRC noted the CC's acknowledgement of the FRC and the IAASB's ongoing work in these areas.

CIMA

27. CIMA believed that the CC should rely on the FRC in this area.[32]

ICAEW

28. The ICAEW stated that matters around audit reports were complicated, and that it was right that the IAASB and the FRC should deal with any changes.[33,34]

ICAS

29. ICAS supported extended reporting requirements. It noted that the working group for its 'Future of Assurance' report recommended:

> A matrix-style report which maps the key risks disclosed by the Board in its report to the assurance processes used to gain assurance over those risks: A substantive discussion of how the audit committee satisfied itself of the appropriateness of management's judgements: Details of the key areas discussed between the audit committee and the auditors, including the main areas of audit challenge.

30. ICAS believed that the catalyst for greater reporting should be from the directors of a company but accepted that the auditor had a valuable role to play in this respect.[35]

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[32] CIMA response to the Remedies Notice, 18 March 2013.
[33] FRC response to the Remedies Notice, 18 March 2013.
[34] ICAEW response to the Remedies Notice, 21 March 2013.
[35] ICAS response to the Remedies Notice, 18 March 2013.

International

31. The Canadian Institute of Chartered Accountants and the Canadian Public Accountability Board noted its support for the work of the IAASB and emphasized its support for efforts to promote international consistency.[36]

32. The Institute of Chartered Accountants Australia noted the work of the IAASB.[37]

33. The Hong Kong Institute of Certified Public Accountants noted the need to ensure that changes in the UK were compatible with steps being taken internationally.[38]

34. IFAC welcomed appropriate comprehensive reporting by the AC and recognized the need for enhanced auditor reporting. It noted the importance of global regulatory convergence and the use of ISAs. IFAC believed that extended auditor reporting complemented remedies to encourage shareholder-auditor engagement.[39]

35. SAICA supported the FRC and IAASB but had not formed a view as to the most effective means of providing such information. SAICA noted that the benefit to the user of the annual report would need to be weighed against the cost. SAICA did not see how this would allow the Mid Tier firms to perform more audits of large companies.[40]

Investment community

Submissions

36. The NAPF stated that it would welcome more informative reporting by both the AC and the auditor, and would give investors more confidence that auditors had exercised appropriate challenge. The NAPF suggested that such reporting might

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[36] CICA response to the Remedies Notice, 18 March 2013.
[37] Institute of Chartered Accountants Australia response to the Remedies Notice, 15 March 2013.
[38] Hong Kong Institute of Certified Public Accountants response to the Remedies Notice, 18 March 2013.
[39] IFAC response to the Remedies Notice, 18 March 2013.
[40] SAICA response to the Remedies Notice, 20 March 2013.

include the ten most contentious issues and a commentary on matters arising during the audit, which would allow better investor engagement. The NAPF emphasized better reporting over more reporting and the need to avoid boilerplate.[41]

37. The CFA Society of the UK supported enhanced auditor commentary and was responding to the FRC consultation.[42]

38. Hermes was supportive of the current proposals of the FRC and was not sure what more might usefully be done beyond the current FRC proposals.[43]

39. Seven institutional investors and a body representing 56 local authority pension funds stated the need for any additional reporting to provide new and real insights into audit quality and/or the performance of the AC and to avoid the risk of boiler-plate. These investors were particularly interested in additional reporting on key areas of audit risk, significant judgements and rationale for the approach taken, other areas of focused discussion by the AC and levels of materiality used by the auditor.[44]

40. The UK Shareholders' Association also supported a coalition of eight investors' submission[45] and stated that there could be a benefit from extended reporting and particularly by the AC.[46]

41. The IMA supported and was engaged in consultations on extended reporting, but thought that beyond the CC offering appropriate support, it did not consider it

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[41] NAPF response to the Remedies Notice, 18 March 2013.
[42] CFA UK response to the Remedies Notice, 14 March 2013; response to investor questionnaire 10 April 2013.
[43] Hermes response to the Remedies Notice, 18 March 2013. Hermes' response is expressly supported by a number of institutional investors: PNO Media (Netherlands), VicSuper (Australia), Public Sector Pension Board (Canada) and Lothian Pension Fund (UK), British Coal Staff Superannuation Scheme (UK), and Mineworkers Pension Scheme (UK).
[44] USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (on behalf of 56 pension funds), London Pensions Fund Authority, Governance for Owners, Environment Agency Active Pension Fund and Sarasin & Partners LLP, response to the Remedies Notice, 19 March 2013.
[45] USS Investment Management, RPMI Railpen, National employment Savings Trust (NEST), Local Authority Pension Fund Forum (on behalf of 56 pension funds), London Pensions Fund Authority , Governance for Owners, Environmental Agency Active Pension Fund and Sarasin & Partners LLP response to the Remedies Notice
[46] UK Shareholders' Association response to the Remedies Notice, 20 March 2013.

necessary for another authority to involve itself in these matters.[47] The IMA cross-referred to its submission to the FRC on the stewardship code, which made reference to ACs explaining their duties but failing to explain how they had discharged those duties and the lack of transparency on both accounting and audit judgements. The IMA referred to suggested Global Disclosure Guidelines for AC reports issued by the Enhanced Disclosure working group.[48]

42. Specifically on the issue of investor concerns, the IMA said that many investors' concerns about the quality of audits were a product of the fact that they felt excluded from the audit process and real findings. Further, the IMA noted that the audit report was the only output whereby investors could form a view as to the value of the audit and its quality. But its usefulness was undermined by the binary nature of the opinion and boilerplate, technical language. Investors may not attach much to terms such as 'reasonable assurance' and 'material misstatement'.

Questionnaire

43. Four investors noted the use of standardized language or boilerplate in audit reports and five felt that the benefit of providing additional information in the audit report would exceed the cost with one investor group stating that the benefits would be small. Three investors similarly referred to the benefit of having more information on the audit.

44. One investor (and supported by another) stated it was in favour of proposals that improved transparency and provided shareholders with the necessary information to cast informed votes when approving the appointment of auditors. It also believed that disclosure of the auditor's tenure and the timing of the last external audit tender

[47] IMA response to the Remedies Notice, 25 March 2013.
[48] www.enhanceddisclosure.org/pdf/guidelines.pdf.

would improve transparency and this would also shift company behaviour towards compliance.

45. Some investors believed that (or were supportive of) recent changes made by the FRC would be effective in providing useful information on the audit or would improve the level of informed voting or would aid in differentiating the relative risk of different companies. For example, Scottish Widows Investment Partnership's response stated 'The proposed revisions to ISA 700, currently in the process of consultation, have the potential to facilitate advanced shareholder dialogue on audit matters'. One Investor believed the current FRC proposals were 'largely sufficient to deliver what shareholders need' but suggested that auditors should comment on whether financial statements were produced on a 'neutral basis' (ie that accounting treatments were neither excessively prudent or aggressive) if neutrality formed part of the relevant accounting framework; in contrast one investor group believed the auditor should confirm the financial statements are prudent.

46. One Investor believed that ACs should be given discretion as to what should be disclosed. A coalition of investors believed that the primary responsibility for reporting audit issues should be the AC's, with the auditor reporting by exception if the AC had failed to make appropriate disclosure.

47. One investor group referred to the proposals in ICAS's report 'The Future of Assurance'.

48. Some investors did not comment on extended reporting requirements in their response to the questionnaire or did not comment fully as they believed that it was too early to comment in full following the recent changes to the UK Corporate Governance Code.

Others

49. The GC100 did not see the need to extend reporting, and noted that it contradicted the drive to 'cut the clutter' and that there was little demand from shareholders for further information. Further, the GC 100 did not see how reporting would lead to greater use of Mid Tier firms.[49]

50. The BBA stated that change at an international level, through the IAASB, would be more appropriate than focusing on a single jurisdiction. The BBA believed that any description of accounting policies or judgements should be for directors to make.[50]

51. The Corporate Reporting Users' Forum supported the work of the FRC.

52. The ABI supported the work of the FRC in this regard.[51]

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[49] GC100 response to the Remedies Notice, 20 March 2013. The response was also supported by Smith & Nephew. However, as noted in paragraph 45, a number of investors believed that the recent reforms would have a positive effect on the level of information available.
[50] BBA response to the Remedies Notice, 18 March 2013.
[51] ABI response to the Remedies Notice, 26 March 2013.

Parties' views: competition duty

FRC

1. The FRC accepted that 'competition clearly pays an important part in [its] mission' to help investors assess and choose between investment opportunities but had doubts as to how useful it would be for the FRC to have a secondary object to promote competition.[1]

2. On the specific question of whether AQR reports could be adapted to make them a basis for comparing statutory auditors, the FRC said that it was willing to review ways in which it could enhance its reporting in order to increase its usefulness to ACs and investors in relation to changing auditors in addition to improving quality. However, it had concerns about the cost implications, as FRC considered that it would need to carry out about six times the number of inspections it carried out at present, and estimated that the bill for inspections would rise from nearly £3.5 million to £9 million. It also had concerns that if the reports were to be used as the basis of comparison between firms, they would have an incentive to challenge the grading made by AQR of individual audits.[2]

OFT

3. The OFT considered that: 'On its own the remedy would probably not be very effective but, with the package of other proposed remedies, would seem to be worth considering, albeit with some caution.'

4. The caution expressed by the OFT was a risk of 'the remedy contributing towards a possible proliferation of bodies with a competition remit, which might suggest that

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[1] FRC response to the notice of a further possible remedy, 19 June 2013.
[2] ibid.

every sector with competition problems ought to have its own "competition regulator"'. The OFT also considered that there was a risk of 'the purpose and quality of AQRs being jeopardized if the FRC felt that they would have to be written in a way that actively promoted competition.'

ICAEW

5. The ICAEW 'in principle endorsed the proposal as set out in the Notice'. It noted that: 'The FRC has key standard setting and regulatory roles in the audit market. Standards and regulations will act to create barriers to entry. ... A secondary duty, appropriately phrased, will help to embed competition considerations into their primary activities.'[3]

6. However, the ICAEW

> do not wish to see the AQRT instructed to consider the promotion of competition as part of their remit. Their focus should be solely on audit quality. ... Any benefit to competition that results from publication and discussion of AQRT findings must be premised on audit quality outcomes being enablers for competition although there may be improvements that can be made in the communication of AQRT findings.[4]

Deloitte

7. Deloitte considered that the FRC was already well placed to take appropriate account of competition issues, but that if the CC considered that it required additional comfort the measure proposed by the CC should be effective, as the FRC would have an additional impetus to consider further action on the basis of its competition objective

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[3] ICAEW response to the Notice of a further possible remedy, 19 June 2013.
[4] ibid.

if the recent reforms on tendering did not have the effect envisaged. Deloitte noted that the FRC had participated in commissioning and conducting reports on competition in the audit market from 2006 onwards.[5]

KPMG

8. KPMG said that it was not clear what change or benefit this remedy option would bring to the supply of statutory audit services to FTSE 350 companies,[6] and considered that it might distort outcomes in the market in two ways. First: 'it might encourage competition to focus on activities that lead to a better "score" in such metrics and divert effort away from the broader range [of] activities that need to be performed.' [7]Secondly: 'such a duty would not sit well alongside the FRC's prudential duty ... it is unclear whether ... FRC would be in a position to comment on the "value for money" of different offers or on audit firms' efficiency.'[8]

9. KPMG considered that if the FRC had a secondary object of promoting competition, it might be necessary for the FRC to recruit staff with the appropriate skills and experience.[9]

10. As the FRC's remit was wider than regulating the audits of FTSE 350 companies, KPMG considered that the broadening of the FRC's objects and its consequential need to procure competition expertise might mean that the remedy was not a proportionate response to the AEC finding.[10]

11. KPMG considered that the CC would 'need to ensure that giving FRC competition powers in relation to FTSE 350 companies does not create a distortion on other

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[5] Deloitte response to the Notice of a further possible remedy, 19 June 2013.
[6] KPMG response to the Notice of a further possible remedy, 19 June 2013, paragraph 1.2.
[7] ibid, paragraph 1.6.
[8] Ibid, paragraph 1.7.
[9] ibid, paragraph 1.8.
[10] ibid, paragraph 1.9.

markets. For example, if AQR reports present quality metrics or rankings ... [it] might lead companies outside the FTSE 350 to choose an audit firm on which such reports are available.'[11]

12. KPMG made specific comments on the suggestion that AQR reports could be adapted to meet a competition objective by noting that audit was a complex and bespoke service. As such, a good assessment of what constituted a high-quality audit and good 'value for money' would necessarily have to be specific to each company: 'It is not clear to us in what way AQR reports could be modified to capture information in a way that is relevant to all companies and yet enables comparability.'[12]

13. More generally, KPMG considered that 'providing the FRC with a secondary duty to promote competition cannot increase shareholder engagement in any helpful way. The audit appointment needs to be based o an assessment tailored to the needs of the particular company and this is best done by ACs.'[13]

PwC

14. PwC supported the FRC having a secondary duty to promote competition, provided it retained its primary focus on audit quality and did not have powers concurrent with the Office of Fair Trading to enforce competition.

15. PwC considered that, when coupled with the other remedies set out in the Remedies Notice, such a secondary duty could assist the Audit Committee compare audit firms and assist shareholders in influencing the auditor appointment decision, and should

[11] ibid, paragraph 1.10.
[12] ibid, paragraph 2.7.
[13] ibid, paragraph 3.2 (b).

not be confined to altering the way the AQR team reported on audit quality but should influence the way FRC engages more broadly with the FTSE 350 audit market..

16. PwC considered that additional benefits of the FRC having such a duty would be that it might influence the guidance the FRC provided to ACs, such as promulgating best practice for running tenders. Also, such a secondary duty would require the FRC to consider the effect on competition in the market of the new tendering scheme.

GT

17. GT considered that

> a secondary duty to promote competition between firms providing audits to FTSE 350 companies would be a useful addition to the CC's package of proposed remedies. ... giving the FRC a duty to consider promoting competition ... would be a useful incentive to improve the way in which AQRT reports are performed and reported.[14]

18. GT considered that 'one way of improving the ability for companies and investors to compare audit firms is to increase the regularity of AQRT reviews on audit firms which are not amongst the four largest firms ... there should be an identical frequency of publishing reports for all 9 major firms.'[15]

19. Of the two types of review carried out by FRC ('thematic reviews' and 'firm reviews') GT recommended that 'FRC's primary review approach is a "thematic" one, focussing on the same audit "theme(s)" (rather than audit client) across all 9 major firms, to provide comparability without compromising the identity of the audit client.'[16]

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[14] GT response to the Notice of a further possible remedy, 19 June 2013.
[15] ibid.
[16] ibid.

20. As regards the content of AQRT inspections, GT supported

> efforts to ensure that the AQRT reports refer specifically, where possible, to the output that investors are concerned about including a review of the ethical practices which the audit firm undertook prior to providing any non-audit services and the level of challenge and scepticism which is evident over material accounting issues.[17]

21. GT also suggested that AQRT should report 'results of the 9 major firms in the same way, to avoid the perception that the largest four firms are different from the others. At present, the reports of the largest four firms are released at the same time under the guise of "Big-4" reports, whilst the other firms are published separately.'[18]

BDO

22. BDO supported the FRC having a secondary object of promoting competition, but did 'not consider it to be an appropriate substitute for any of the other remedies which the CC has been considering'.[19]

23. In particular, BDO considered that

> Companies and shareholders need more of the right information, not simply more of the information which is currently produced. A 'rebalancing' of AQRT effort, coupled with a secondary duty for the FRC to promote competition between audit firms, could help companies and shareholders to compare auditors more easily and assist shareholders

[17] ibid.
[18] ibid.
[19] BDO response to the Notice of a further possible remedy, 11 June 2013, paragraph 1.

> to influence the auditor appointment decisions of companies in which they hold shares.[20]

Kingston Smith

24. Kingston Smith considered that the proposed remedy of giving the FRC a secondary object of promoting competition was 'one which would be challenging to make effective in practice'.[21]

25. Kingston Smith had a potential concern as to the composition of the FRC, as it understood

> the majority of the serving members of the FRC and its various subsidiary bodies – including the AQR – ... are drawn from Big Four backgrounds ... such individuals do not have any direct experience of the high quality of service that can be provided by mid-tier audit firms and there is therefore a risk that the 'alumni effect' may apply to some extent at the FRC.[22]

26. For this reason if the FRC had a secondary object of promoting competition, Kingston Smith recommended that 'the serving members of the FRC and its various bodies need to be drawn not just from the largest firms but also from the mid tier so that the FRC ... has a wider direct experience of the mid tier firms and the quality of their service ... '[23]

27. A further concern of Kingston Smith was that

> in any 'increased transparency' regime there could be a tendency for companies and investors to place more weight on any findings of audits

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[20] ibid, paragraph 4.
[21] Kingston Smith response to the Notice of a further possible remedy, 10 June 2013.
[22] ibid.
[23] ibid.

requiring significant improvement at mid-tier firms than at Big Four firms; and of such instances at mid tier firms being viewed as evidence of systemic issues but similar instances at Big Four firms being viewed as isolated 'hiccups'.[24]

28. Kingston Smith considered that any additional reporting could be onerous on the firms concerned; 'extending the scope and frequency of AQR reporting would in our view place a disproportionate burden on mid tier firms; ... most mid tier firms would find any increased reporting to be extremely onerous.'[25]

Mazars

29. Mazars considered that giving the FRC a secondary object to promote competition in the FTSE 350 audit market would not be effective unless there were 'significant changes in its composition, including at board level' and that 'it would also be important for the FRC to establish a new body, with balanced membership, within its structure to deal with promoting competition'.[26]

30. In Mazars' view 'the FRC has been very clear in recent times in stressing that it is not a competition regulator ... Furthermore, the FRC's record in promoting competition, for example, in its implementation of the recommendations of the Market Participants Group, has not been very successful.'[27]

NAPF

31. The NAPF supported giving the FRC a secondary power to promote competition, so long as this formed part of a package of remedies not a remedy on its own, as it

[24] ibid.
[25] ibid.
[26] Mazars response to the Notice of a further possible remedy, 17 June 2013.
[27] ibid.

'believe[s] that a more tailored set of publicly available results regarding the performance of all audit firms in the market would be helpful'.[28]

32. The NAPF considered that 'it is important that the emphasis is on competition to improve the quality of audits at a reasonable price, rather than on price alone.' It noted that 'the FRC itself will need to be minded of any conflicts it may itself have, perceived or actual, which may hinder its ability to fulfil this [competition] objective to the satisfaction of its stakeholders.'[29]

Ten investors and corporate governance advisers

33. Ten entities involved in investment management and corporate governance stated that they did not oppose the proposed remedy, so long as it was not used as the sole remedy.[30]

34. However, the ten did not understand how the remedy might lead to further switching, as 'the FRC is more likely to seek to influence auditor behaviour whereas the AECs identified in ... Provisional Findings showed clearly that it is the behaviour of companies in re-appointing the same firm for long periods that is the behaviour that needs to change.'[31]

35. In addition, the organization drew attention to the importance of regulatory independence, noting that: 'The FRC's independence from the auditing profession

[28] NAPF response to the Notice of a further possible remedy, 28 June 2013.
[29] ibid.
[30] USS Investment Management; Governance for Owners; RPMI Railpen; Legal & General Investment Management; London Pensions Fund Authority; Royal London Asset Management; National Employment Savings Trust (NEST); Sarasin & Partners LLP; UK Shareholders' Association; PIRC Ltd (European Corporate Governance Advisors); 28 June, 2013 response to the notice of a further possible remedy, paragraph 2.
[31] ibid, paragraph 4.

has been questioned in some quarters for drawing heavily on accounting firms staff ... for professional input.'[32]

GC100

36. The GC100 Group was in favour of increasing the transparency of AQR reports and more frequent inspection by the FRC of Mid Tier firms, but did not consider it appropriate to give the FRC a secondary duty to promote competition between firms providing audits to FTSE 350 companies. This is because the GC100 Group considered that the primary role of the FRC had its emphasis on audit quality.[33]

[32] ibid, paragraph 5.
[33] GC100 response to the Notice of a further possible remedy, 28 June 2013.

Parties' views: Mandatory switching

Investor community

AXA Investment Managers

1. AXA Investment Managers' (AXA) preferred approach to increasing competition was the FRC recommendation that FTSE 350 companies should put their external audit contract to tender at least every ten years, on a comply or explain basis. AXA believed that this approach would shift market behaviour, improve disclosure and transparency around the audit process and allow companies and investors to determine which audit firm was able to provide services which suited the company's particular requirement. AXA suggested that sufficient time should be allowed to examine the effectiveness of this approach in dealing with the concerns raised by the CC and only if proven ineffective should mandatory rotation be considered.

Association for Financial Markets in Europe[1]

2. AMFE was strongly opposed to the principle of mandatory rotation of auditors, particularly insofar as this would affect the largest multinational financial groups, where it believed mandatory rotation could be counterproductive, with serious risks of significant disruption of the audit process and a reduction of overall audit quality.

3. AMFE said that many FTSE 350 firms had significant interests outside the UK, and would therefore be directly and/or indirectly subject to non-UK regulation which may affect, and potentially restrict, their choice of statutory auditor in the UK. This was particularly the case for those FTSE firms whose primary listing was on a non-UK exchange. While this may be a relatively small proportion of the 350, they included some of the very largest firms.

[1] AMFE response to the Remedy Notice.

4. AMFE said that the choice of auditor for the largest global companies was in practice limited to the Big 4 firms. AMFE also said that many of these companies already used a second Big 4 auditor to carry out non-audit work and might have reservations (because of perceived capability, competitive issues etc) about using another. AMFE said that it was therefore quite possible such companies could find their choice limited to, at best, a single alternative.

Baillie Gifford

5. Baillie Gifford supported mandatory rotation every ten years. The main benefit was said to be the removal of the current assumption that 'if the auditor has changed there must be a negative reason for it'. This was said to be a significant period of time for the auditor to 'get to know' the company but hopefully would not be so short that competition between the Big 4 would become so intense that there was extreme price competition, a 'race to the bottom', which would result in audit quality being compromised.

6. Baillie Gifford said that the obligation should be mandatory with a provision, for exceptional circumstances, to seek a waiver from the FRC. It would view exceptional circumstances as including: within 12 months of merger or acquisition activity; and the year following 'qualified' audit report. Baillie Gifford recognized that it takes time for an auditor to fully understand a company's business operations and that there was a balance to be struck between an auditor's understanding of the business and frequency of rotation.

Blackrock[2]

7. Blackrock considered that there were risks associated with mandatory rotation such as the loss of institutional knowledge and a reduced incentive for audit firms to invest

[2] Blackrock response to the Remedy Notice.

in the audit relationship be relocating the most qualified personnel or investing in travel and training. Blackrock said that audit risk may be highest during the first few years of an engagement given the lack of in-depth and historical knowledge.

8. As an audit client (rather than investor), Blackrock said that due to US SEC requirements, mandatory rotation at regular intervals could be difficult and costly to its corporate and investment company shareholders, and could be required at appoint when audit risk was highest such as following an acquisition.

Hermes

9. Hermes did not support mandatory rotation. Most significantly, it was concerned that removing key decisions from the hands of audit committees risked undermining the more powerful possible remedy on enhancing the accountability of the auditor to the audit committee. Hermes considered that the costs of this approach might well overwhelm the benefits.[3]

10. Hermes added this would have detrimental effects for shareholders: by removing two of the key decisions from the hands of the audit committee (the timing of an audit tendering process and barring one possible candidate for the audit) it risked disempowering the audit committee, which as the CC noted (and indeed, seeks to bolster with other recommendations) was in the front line of ensuring that auditors delivered quality audits for shareholders and that the audit market operates. Hermes said that a disempowered audit committee was less likely properly to carry out its key role in calling the auditor to account and ensuring that the company properly responded to auditor comments, and so such an audit committee was much less likely to serve shareholder interests, as well as much less likely to play an active and intelligent role in ensuring that there was a properly active market for audit services.

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[3] Hermes responses to the provisional findings.

Kames Capital

11. Kames did not favour mandatory rotation of the audit firm as it could be costly, disruptive and ultimately ineffective for the following reasons: the technical ability required to audit certain industries may mean that the opportunity set was actually reduced if the incumbent could not retender (unless Mid Tier firms were able to commit further resources); the risk that a new auditor must be appointed during a critical period (eg during a merger or acquisition); and the risk that the real reason for the incumbent stepping down would be concealed.[4]

Legal and General Investment Management[5]

12. L&G believed that there should be mandatory rotation of a firm every 15 years in order to preserve the independence and integrity of audit activity for shareholders. L&G said that this would encourage rotation among the audit firms, increase competition and shift accountability. L&G said that due to the concentration of the audit market, companies should have a contingency plan to appoint a replacement audit firm should one suffer significant damage or loss in confidence which has happened in the past.

13. L&G believed that 15 years was a more realistic and flexible period for companies. L&G said that a mechanism whereby the FRC could grant relief from this requirement should only be on exceptional grounds and shareholders would expect a full explanation disclosed in the Report & Accounts. In addition, the company should state when they would expect to return to normal practice of rotation.

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[4] Kamas response to the Remedy Notice.
[5] L&G Investment Management response to the Remedy Notice.

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14. [✂] did not support mandatory rotation for FTSE 350. It said that this would not benefit the shareholders and that the benefits would be speculative and likely to be offset by costs of disturbance.

National Association of Pension Funds[6]

15. NAPF said that a cap on audit firm tenure of around 15 years would provide an effective and proportionate response to the fundamental problem of misaligned incentives facing auditors.

16. NAPF believed that where auditors held office for long periods this could materially impact their independence and objectivity which were vital to ensuring audit quality. There was the risk of a reduced willingness to challenge management, especially where audit firms fostered other non-audit relationships with their audit clients. NAPF was therefore of the opinion that the current situation where audit firms often retained a client for a number of decades was not satisfactory.

17. NAPF believed that a 'fresh pair of eyes' introduced a check on incumbent audit firms' work, and ensured the audit was not unduly influenced by historical judgements as well as the client's management. NAPF said that any waiver should be a tightly controlled mechanism subject to shareholder approval.

Newton Investment Management

18. NIM favoured a requirement to switch every 15 years on a comply or explain basis. It considered that the additional costs would be outweighed by the benefits. [✂]. NIM considered that mandatory tendering or rotation needed to fit with the provision of a wider explanation of the audit. In particular, the description in audit report should be

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[6] NAPF response to the Remedy Notice.

discursive on the weaknesses in financial systems; auditor judgements; and disagreements with management, ie provide more than the current boilerplate reports.

[✂]

19. [✂] said that requiring more frequent rotation would mean that audits were performed more often than not by a team that was on the learning curve which would be inefficient, costly and could reduce average audit quality. [✂] noted the significant costs to firms and companies with switching auditor. For large companies significant effort was required by the auditor to develop a sufficient understanding of the business and by the company to get the auditor up-to-speed. The first year of an audit relationship was therefore generally expensive and time-consuming but without the benefit of the auditor having an in-depth understanding of the business. It was usually the second or third year that the audit team had developed sufficient insight to be able to successfully challenge management on accounting and business practices.

20. [✂] also said that currently, firms absorbed the set-up costs of an audit, but mandating frequent tendering would make them less likely to do so and would therefore increase the overall cost of audit.

21. [✂] said it was not clear that mandatory rotation would increase the level of effective competition in the audit market. Currently there were few realistic options for the large companies particularly those in specialist markets or operating across wider geographic areas. What was needed is more investment by the Mid Tier firms in expertise and geographic reach.

Royal London Asset Management

22. RLAM said that it did not believe that using the same firm for decades without any chance of movements aided market or investor confidence in financial reporting. It was of the view that there were dangers in relationships becoming too close if they persisted for too long. It therefore supported mandatory rotation every 14/15 years as a backstop to relationships as a reasonable compromise between them being too short so that organizations failed to commit fully to the expectations investors would place upon auditors and too long so that the relationship becomes too close. RLAM considered some higher costs would be worth paying for greater market confidence in the degree of scrutiny applied to audits.

Coalition of 7 investors and a body representing 56 local authority pension funds'[7]

23. This group supported a limit on audit firm tenure of 15 years. It said that this would provide an effective and proportionate response to the fundamental problem of misaligned incentives facing auditors. It said that this would be long enough for ACs to have the scope to set a maximum tenure period to suit their company's complexity and size, and would provide sufficient time for flexibility in the event of an unexpected crisis. It said that ACs should outline their reasoning for the choice of tenure length to shareholders.

24. It said that there should be a 'clear water' period of at least five years before an auditor could be reappointed. Audit quality (and ultimately trust in capital markets) depended on real and perceived auditor independence. Independence provided a basis for ensuring professional scepticism and prudence in analysis and willingness to robustly challenge management. Currently, it was very difficult for shareholders to ascertain whether auditors were independent of the executive. Audit opinions were

[7] See USS Investment Management, RPMI Railpen, National employment Savings Trust, Local Authority Pension Fund Forum, London Pensions Fund Authority, Governance for Owners and Environmental Agency Active Pension Fund response to the Remedies Notice.

boilerplated and shed little light on the discussions that took place between audit partners, company management, and ACs.

25. It said that it was widely accepted that the audit process needed to become more transparent. Transparency was critical to ensuring independence of the auditor from executives and from their own historical judgements, and also provided a basis for shareholders to hold auditors to account. The majority of investors found the average length of tenure in the FTSE 350 to be excessive.

26. It said that an upper limit on audit tenure would be effective because it would introduce a certain and regular check on the incumbent auditor's work. The fresh pair of eyes would provide information that shareholders could use to hold outgoing auditors to account for past work; and, consequently, a fundamental shift in accountability to shareholders. Market failures associated with asymmetric information and diffuse ownership were severe and shareholders in this situation required protection.

The FRC[8]

27. The FRC opposed mandatory rotation because it would reduce choice and may have an adverse impact on quality. The FRC said that companies needed to be able to secure the best auditor for their business and should not have their choice of auditor artificially constrained. This was said to be particularly necessary when not all audit firms had the required expertise such as insurance and banking.

28. The FRC said that there was also a risk that mandatory rotation would effectively undermine the authority of the AC operating in the best interests of investors by

[8] FRC response to the Remedy Notice.

taking the question of reappointment out of their hands. The FRC said that would be inconsistent with the CC's views on the role and accountability of the AC.

29. The FRC said the prospects of rotation did not guarantee that new firms would emerge. The FRC had heard that Mid Tier firms were not contemplating investing to enter the market for major and complex audit clients in the very top of the FTSE. In some sectors only two or three firms currently competed for work, rotation could therefore lead to a danger of a company having no effective choice.

30. The FRC said that it would be reluctant to take on the role of granting waivers as this would fracture the line of accountability from the board to shareholders with whom the ultimate decision on whether to accept an explanation should rest.

FTSE 350 companies

31. Aggreko did not support mandatory rotation. Aggreko said that mandatory rotation, potentially every five to seven years could compromise audit quality. Aggreko said that the key issue was audit quality, that the audit was an integral part of its risk management, and that it therefore assessed the quality of its external audit rigorously each year. If assessed as poor, Aggreko would change auditor.[9]

32. Barclays strongly believed that mandatory rotation would increase risk. Barclays said that any change in audit firm would result in the company's external auditor being less familiar with the business which would compromise audit quality and the effectiveness of the assurance provided to shareholders. In particular, in the early years of the engagement, auditors unfamiliar with the business would be less able to provide a robust challenge to management, especially in complex and judgemental areas for banks such as the level of impairment allowance, the valuation of illiquid

[9] Aggreko plc response to the Remedy Notice.

instruments, accounting for structure transactions and disclosure of financial risks. Barclays said that it currently provided banking services to many audit firms and to audit partners, employees and their relatives, and that an enforced change in auditor would be immensely disruptive to these relationships due to the requirement to maintain auditor independence.[10]

33. Berkeley said that there were benefits perceived by companies to maintaining audit engagements over a number of years due to the embedded understanding of a business that the incumbent would enjoy. Berkeley did not consider that this undermined the company's ability to tender and/or switch if appropriate to protect shareholders' interests, and said that this decision sat best with the AC rather than being governed by the external framework which would not take into account the current circumstances of the company.[11]

34. BHP Billiton did not support the mandatory rotation as it would sharply increase management time and the costs associated with audit and it was not clear that it would serve as a mechanism to increase the number of FTSE 350 audits held by Mid Tier firms. This was said to be because of the fundamental scale and reach of many FTSE companies and the resulting need for an auditor that is large and international in operation.[12]

35. BHP also said that mandatory rotation could force companies to change auditor at a time when the existing auditor's understanding of the business would benefit the audit process, for example in the event of a corporate action. BHP said that, in practice, the options for rotation were limited by the impact of other non-audit services received by the company from other providers. Mandatory rotation of

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[10] Barclays plc response to the Remedy Notice.
[11] Berkeley Group plc response to the Remedy Notice.
[12] BHP Billiton plc response to the Remedy Notice.

auditors would have a knock-on effect of requiring rotation of these other services so further impacting negatively on management time and overall costs.

36. BHP said that the time that a new auditor would take to fully understand the business introduced risk. While not insurmountable, the risks associated with mandating change at every company in the FTSE 350 over too short a time frame would be likely to be high. BHP considered that the risks would be greater than those inherent in the current environment where it appeared that a few companies, or in extreme cases, sectors, had governance failings that could be addressed by the FRC changes already in place.

37. BT Group considered that the risks associated with mandatory rotation would be likely to outweigh the benefits. When a FTSE 100 company changed auditor there was said to be a period of investment in the transition which was likely to involve senior management and to be disruptive for the business and *in extremis* to impact on business performance. BT considered that it should be the AC's decision as to when it would be appropriate to change auditor. BT said that a change in team members and wider consultation outside the core team could be effective in bringing new insight or challenge.[13]

38. BT considered that losing the knowledge, experience and understanding of the incumbent firm would present a significant burden on management, which would need to educate a new team. BT said that there was also a heightened risk that an issue would be missed. BT said that large companies faced limited choice when considering an auditor as companies commonly engaged the other audit firms to provide services that the incumbent auditor could not such as tax advice and HR consultancy. BT said that such services must be discontinued for at least two years

[13] BT Group plc response to the Remedy Notice.

before a firm could meet the test for independence and eligibility for consideration as an auditor.

39. Lloyds Bank plc did not support mandatory rotation. Lloyds said that if an audit firm could demonstrate through a tender process that it was still the best audit service provider for the company, it seemed counter-productive to prohibit the company from engaging that firm.[14]

40. RBS opposed mandatory rotation which it said would simply lead to rotation within an existing pool of those firms able to service a business of the Group's size and complexity. RBS said that mandatory rotation would have other unattractive consequences: RBS's ability to source high quality advice from a competitive market would be severely compromised if audit firms qualified to perform the Group's audit were to maintain full audit independence so as to be in a position to tender.[15]

41. SABMiller did not support mandatory rotation as its AC wished to appoint the best firm for the company having completed its necessary review. SABMiller said that if the outcome of a tender process confirmed that the incumbent auditor was best qualified for the role, it made no sense to appoint a second best alternative given the length of time and resources required in the early years following a new appointment.[16]

42. SABMiller said that the proposal failed to give due recognition to, and undermined the role of, the AC which had developed hugely in recent years and which now was the dominant influence in tendering decisions. SABMiller said that, like other large FTSE 100 companies, there were a limited number of audit firms which could be

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[14] Lloyds Bank response to the Remedy Notice.
[15] RBS response to the Remedy Notice.
[16] SABMiller response to the Remedy Notice.

considered for appointment as the company's auditors. In addition to the expertise, experience, size and international scope of the auditor, SABMiller would typically not wish to appoint an external auditor which already undertook extensive non-audit services for the company (because of the need not only to tender and change the provider of audit services, but also to tender the non-audit services previously provided by the new auditor), and had close links with a key member of financial management or the audit committee, or already acted as auditor to a major competitor.

43. SABMiller believed that mandatory rotation of audit firms diminished the authority of the Board to manage the company's affairs. There was no evidence from the very limited application of automatic tendering in other countries that it had done anything for audit quality. It believed that it was more likely to undermine quality because of the time which it took for a new auditor to get up to speed, particularly in complex groups.

44. [✂] plc was strongly opposed to mandatory rotation. Chief among its concerns were risks it would pose for audit quality and precluding the incumbent from tendering regardless of their performance reduced choice.

45. Segro plc did not support mandatory rotation of audit firm as it did not necessarily serve to reduce concentration in the audit market. Additionally, auditor appointment should be maintained at the discretion of shareholders and not become something that was imposed on them.[17]

46. Smiths Group plc did not support mandatory rotation as an auditor with previous experience of auditing a company could often use this knowledge to provide a more

[17] Segro plc response to the Remedy Notice.

robust and challenging audit. There were therefore benefits for shareholders to a degree of continuity in the relationship. Smiths considered that the benefits of continuity and renewed challenge were appropriately met by the requirement for partner rotation.[18]

47. Smith and Nephew plc supported more regular tendering but not mandatory rotation primarily as it would have very little choice of auditor: the ACC was a former partner of one of the Big 4 firms and so it would not want to appoint that firm; Mid Tier firms did not have the required experience, scope and international range; and it had significant relationships for the provision of non-audit services with the remaining two Big 4 firms. If Smith and Nephew plc were to appoint one of these two firms, it would have to retender these non-audit services.[19]

48. Stagecoach (and BTG plc) did not support mandatory rotation of audit firms. Stagecoach believed that this risked introducing significant extra cost into the external audit process whilst at the same time potentially reducing its effectiveness. Stagecoach did not believe that the 'familiarity breeds contempt for objectivity' line of argument held up when applied to audit firm-company relationship. Any tendency in that direction would be fully dealt with by audit partner rotation rules.[20]

49. Stagecoach said that changing audit firms regularly introduced periods (sometimes years) where the loss of the history of understanding of a client business could materially and negatively affect the quality of the audit enquiry. Stagecoach believed that the role now played by audit committees in overseeing external audit acted as an effective counterbalance to any risk of auditors seeking to 'please management

[18] Smiths Group plc response to the Remedy Notice.
[19] Smith and Nephew plc response to the Remedy Notice.
[20] Response of ACC of Stagecoach plc/Chairman of BTG plc to the Remedy Notice.

rather than shareholders'. Stagecoach also disliked the restriction of choice for audit committees that would be implicit in any compulsory rotation requirement.

50. Tate & Lyle believed that the AC was best placed to represent shareholders' interests in deciding on the timing of any change to auditor taking into account the circumstances of the company at the time and whether continuity of auditor might outweigh the perceived benefits of change. T&L also had considerable concerns that removing the incumbent from tendering further restricted choice particularly for multinational companies where there was already limited choice of firms with the required geographic reach to deliver a consistent and integrated audit.[21]

Big 4 firms

Deloitte

51. Deloitte said that mandatory rotation would not address the AEC in the three ways identified in the Remedies Notice and that it was demonstrable that the remedy would be less effective than mandatory tendering. In particular:[22]

(a) the CC had not explained why providing that an incumbent auditor could not be reappointed would align the auditor's interests with *any* party—whether shareholders, management or otherwise;

(b) a reduction in the barriers to non-top-tier audit firm selection by providing greater opportunities for non-top-tier firms to tender for FTSE 350 audits was a feature of mandatory tendering and not mandatory switching; and

(c) to remove (by overriding) barriers to more frequent tendering and so increase companies' bargaining power was also a feature of mandatory tendering and not mandatory switching.

[21] Tate & Lyle plc response to the Remedy Notice.
[22] Deloitte response to the Remedies Notice, paragraph 4.2.

52. Deloitte said that mandatory rotation would risk creating distortions of the market which appeared to constitute exactly the sort of distortions which a competition authority would in the ordinary course strongly resist and/or seek to remedy (ie penalizing effective providers, reducing choice and competition).[23]

53. Deloitte added that for such a distortive remedy, it would be incumbent on the CC to show very substantial customer detriment, which the remedy would effectively address. Deloitte said that the link between the posited remedy and the alleged features of the AEC was not properly explained or evidenced and that the evidence in the provisional findings as to the customer detriments that this remedy purported to address did not meet the required standard.[24]

54. Deloitte said that investors and academics were opposed to mandatory rotation.[25] Deloitte said that there would be a loss of customer benefits from loss of investment in relationship between auditor and company.[26] If auditor rotation was mandated (without any waiver provisions), it could be very costly, to the detriment of shareholders, for some companies to comply.[27] Deloitte therefore considered that a form of waiver was necessary to ensure that companies be able to benefit from a sufficiently flexible environment to deal with unpredictable situations that are beyond their control.[28]

EY

55. EY said that the CC had not explained why it considered mandatory rotation would ensure greater independence and provide the benefit of a fresh approach. EY said

[23] Deloitte response to the Remedies Notice, paragraph 4.3.
[24] Deloitte response to the Remedies Notice, paragraph 4.4.
[25] Deloitte response to the Remedies Notice, paragraph 4.5.
[26] Deloitte response to the Remedies Notice, paragraph 4.6.
[27] Deloitte response to the Remedies Notice, paragraph 4.9.
[28] Deloitte response to the Remedies Notice, paragraph 4.12.

that the remedy appeared to be based on no more than an assumption that switching for switching's sake was desirable.[29]

56. EY said that mandatory firm rotation risked harming shareholder interests and undermining corporate governance and was an unnecessarily blunt instrument with potential negative effects that should be avoided.[30]

57. EY said that companies and their shareholders should be able to appoint the audit firm—and the audit partner—that best met their needs. Mandatory firm rotation would automatically disqualify the incumbent audit firm's partners from the pool of candidates, thereby imposing a further unwarranted restriction on choice.[31]

58. EY said that mandatory rotation would weaken a key element of the existing corporate governance structure. The fundamental purpose of corporate governance was to make sure that companies operated in the interests of shareholders including when appointing auditors. Mandatory firm rotation would limit the ability of the AC to carry out this duty.[32]

59. EY said that companies were unlikely to initiate a tender process significantly before the end of the set period. If the incumbent audit firm knew it could not be reappointed at the end of that period, this would have the inevitable impact of reducing the recurring competitive pressures experienced by incumbent auditors. Increasing the focus of competition at set intervals at the expense of continuing competition would be a perverse outcome.[33]

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[29] EY response to the Remedies Notice, paragraph 3.1.
[30] EY response to the Remedies Notice, paragraph 3.3.
[31] EY response to the Remedies Notice, paragraph 3.3a.
[32] EY response to the Remedies Notice, paragraph 3.3b.
[33] EY response to the Remedies Notice, paragraph 3.3c.

60. EY said that longer audit tenures could give rise to significant advantages and that it should be for companies and shareholders to decide whether or not they wished to benefit from those advantages. In particular, an audit firm attained significant knowledge and understanding of a company over time, as well as an awareness of the risks it faced. Such knowledge could enhance professional scepticism and audit quality.[34] For example:

(a) experience and knowledge of the personalities and abilities of individuals might prompt increased scepticism;

(b) a detailed knowledge of historical accounting positions or transactions enabled an auditor to assess consistency in approach and better to assess management motivations; and

(c) institutional knowledge helped audit firms to identify broader issues and emerging risks, or to 'connect the dots' between what might otherwise appear to be isolated issues.

61. EY was concerned that the CC had not fully appreciated the resource challenges posed by mandatory rotation and the long-term negative impact that it could have on audit quality. EY said that forced changes of auditor would increase the overall cost of the audit while not necessarily increasing—indeed potentially threatening—audit quality. EY said that although companies and audit firms obviously could and did manage transitions and new audit client risks, this was not without cost or risk.[35]

62. EY said that due to the learning curve that audit firms faced with any new audit client, audits could be less efficient at the beginning of an engagement, and present a higher level of audit risk.[36]

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[34] EY response to the Remedies Notice, paragraph 3.3d.
[35] EY response to the Remedies Notice, paragraph 3.4.
[36] EY response to the Remedies Notice, paragraph 3.4a.

63. EY said that companies would face repeated distraction and disruption due to the need to educate the new audit firm about their business and operations. Even if the incoming auditor accepted a lower audit fee, there would be a significant extra time commitment from senior personnel at the audited company to help explain to the incoming auditor the company's business, internal control environments, processes and corporate structures.[37]

64. EY said that these audit efficiency and risk issues would be compounded for complex global companies with operations in multiple countries.[38]

65. EY said that there was no evidence that the many negative effects of mandatory firm rotation would be outweighed by any improvements in audit quality, lower audit fees or enhanced innovation. Research suggested that mandatory firm rotation in South Korea and Italy had not resulted in a significant increase in audit quality and experience in these countries demonstrated that enforced limitations on audit tenure could result in greater concentration and increased overall costs.[39]

KPMG

66. KPMG said that mandatory rotation would reduce the number of audit firms between which companies could choose by one and would be expected to reduce competitive pressures on audit firms.[40]

67. KPMG said that there was no evidence in the provisional findings that length of tenure had an impact on independence. Insisting on a change of audit firm did not imply that there would be a 'fresh approach to the audit of the company' that would not otherwise be achieved to a substantial extent by the rotation of the audit

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[37] EY response to the Remedies Notice, paragraph 3.4b.
[38] EY response to the Remedies Notice, paragraph 3.4c.
[39] EY response to the Remedies Notice, paragraph 3.5.
[40] KPMG response to the Remedies Notice, paragraph 4.1.3.

engagement partner. KPMG also said that, in circumstances where management's interests were indeed different to those of shareholders, it was more likely that management would seek to influence the selection of an audit firm which might be at least if not more accommodating in its views on accounting judgements than an incumbent.[41]

68. KPMG said that the FRC and investor groups did not support mandatory rotation on the basis that it would reduce audit quality.[42]

69. KPMG estimated part of the costs associated with mandatory rotation at £66 million, £54 million or £46 million respectively if the remedy was implemented on a 7-, 10- or 14-year basis, as well as a cost associated with increasing FTSE 350 companies' cost of capital which might be in the region of £1 billion. The costs of increased risk of audit failure, reduced choice, a risk of regulatory arbitrage are all said to be taken into account as part of the estimate of the increase in audit firms' cost of capital as a result of this remedy, which would have a substantial impact on the UK economy as a whole. The substantial costs of increased administrative burden associated with resolving NASs independence issues and international coordination would be additional to these costs.[43]

70. KPMG said that because of the investments necessary at the beginning of each audit engagement, frequent switching was an inefficient outcome in the supply of statutory audit services. Any increase in the rate of switching above current levels would give

[41] KPMG response to the Remedies Notice, paragraph 4.1.4.
[42] KPMG response to the Remedies Notice, paragraph 4.1.5.
[43] KPMG response to the Remedies Notice, paragraph 4.2.1.2.

rise to a loss of efficiency and quality which would impose significant additional costs on market participants which would substantially exceed any potential benefits.[44]

71. KPMG said that it was necessary for audit firms to commit a considerable amount of additional time during the initial period of a new engagement in order to gain a comprehensive understanding of the structure and complexities of a company. The GAO (2003) study report is said to have calculated that the additional support costs to a public company's management would range from 11 to 39 per cent of the initial year audit fee.[45]

72. KMPG estimated that the costs to audit firms, in terms of duplication of investments in gaining an understanding of a business in the first year of an audit would be between £300,000 and £558,000, and on average £429,000 for every change in audit firm. KPMG expected this to be a substantial underestimate for the largest and most complex FTSE 350 companies.[46]

73. KPMG said that there was a significant risk that mandatory rotation would dampen competitive pressure outside of the prescribed windows for rotation as it would be far less likely that a company would be able to explain a change in audit firm to the satisfaction of investors outside of the mandatory rotation window. In particular, it was far more likely that any switch of audit firm outside of the mandatory rotation window would be seen as being associated with a serious problem with the company or with the audit, and so create a far greater risk of an adverse investor reaction.[47]

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[44] KPMG response to the Remedies Notice, paragraph 4.2.2.1.
[45] KPMG response to the Remedies Notice, paragraph 4.2.2.2.
[46] KPMG response to the Remedies Notice, paragraph 4.2.2.3.
[47] KPMG response to the Remedies Notice, paragraph 4.2.3.1.

KPMG said that audit firms would be aware that the threat of companies switching audit firm outside the prescribed window was weaker.[48]

74. KPMG also said that an important part of the current competitive environment is the uncertainty on the part of audit firms about when the next tender opportunity would arise, which ensured that audit firms had substantial incentives to compete fiercely on every tender opportunity.[49] KPMG said that with mandatory rotation, firms would know exactly when the next opportunity to win a new client from a rival was likely to arise and that this was likely to reduce the incentives on audit firms to compete so fiercely to retain their existing clients, if they could be confident of other opportunities to make up this loss in the near future.[50]

75. KPMG said that Arruñada and Paz-Ares (1997) found that mandatory firm rotation led to an increase in audit fees of between four and 15 per cent just because of increased in costs, and that these could be higher if there was also a reduction in competition. KPMG applied a 4 per cent increase to the total audit fees, amounting to £33 million a year which it considered to be conservative.[51]

76. KPMG said that switches that occurred at the point of mandatory rotation would send less of a negative signal about an audit firm's performance which would reduce the reputation effect associated with switching, and therefore the incentives for audit firms to deliver innovative high quality audits at competitive prices in order to maintain reputation.[52]

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[48] KPMG response to the Remedies Notice, paragraph 4.2.3.2.
[49] KPMG response to the Remedies Notice, paragraph 4.2.3.3.
[50] KPMG response to the Remedies Notice, paragraph 4.2.3.4.
[51] KPMG response to the Remedies Notice, paragraph 4.2.3.7.
[52] KPMG response to the Remedies Notice, paragraph 4.2.4.2.

77. KPMG said that Mid Tier firms might be less incentivized to participate in tenders under mandatory rotation, as the time horizon for the recoupment of investment in, for example 'bench strength', would be reduced. KPMG also said that mandatory rotation might lead to one of the largest four audit firms choosing to drop a certain sector (or geographic specialization) from its skills range if there were few companies and it knew that it would have only a short horizon with which to develop knowledge and build 'bench strength' in this area.[53]

78. KPMG said that the GAO (2003) study found that 54 per cent of Tier 1 firms believed that mandatory rotation would be likely to reduce the number of firms competing for audits of public listed companies, and that 55 per cent of Tier 2 firms were uncertain of whether they would still provide audit services to public listed companies if mandatory rotation was introduced.[54]

79. KPMG said that the Global Audit Committee Institute Survey 2013 found that the very large majority of ACs (in the UK and globally) thought that mandatory rotation would not increase audit quality. KPMG said that the increased hours devoted to the audit in the initial period of a new engagement would not fully eradicate this risk. This risk contributed to loss of investor confidence, which imposed additional costs.[55]

80. KPMG said that it was well-established in the academic literature that companies' governance standards affect their cost of capital. Most recently, Chen, Chen and Wei (2009) show that good governance was associated with a lower equity cost of capital, and Bhorjraj and Sengupta (2003) showed that there was a cost of debt effect. KPMG said that Lambert, Leuz and Verrecchia (2007) found that increasing the

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[53] KPMG response to the Remedies Notice, paragraph 4.2.4.3.
[54] KPMG response to the Remedies Notice, paragraph 4.2.4.5.
[55] KPMG response to the Remedies Notice, paragraph 4.2.4.5.

quality of mandated disclosures should generally reduce the cost of capital for each firm in the economy.[56]

81. KPMG said that mandatory rotation was associated with a reduction in audit quality as there was a greater risk of audit failure in the first years of an engagement. This was exacerbated by companies no longer being able to appoint the audit firm with the experience and skill-set most closely matched to its needs, if this audit firm was the incumbent at the point where mandatory rotation was required.[57] KPMG said that even a small change in cost of capital would have an enormous economic impact.[58]

82. KPMG said that large, multinational companies had a choice over which index (or indices) to list on. If listing in the UK was associated with being forced into mandatory rotation, then this could lead to some companies choosing to list in other jurisdictions.[59]

83. KPMG said that with mandatory rotation there was a greater risk that audit firms would have to interrupt the provision of NASs, which would impose costs directly on companies, particularly if the AC chose an audit firm that was also considered by company management to be the most suitable for certain NASs.[60] KPMG said that this might reduce the likelihood of companies buying NASs from firms that also provide audit services, and of audit firms in bidding for non-audit work. The effects on markets for NASs could be reduced competition, reduced quality and costs of transition.[61]

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[56] KPMG response to the Remedies Notice, paragraphs 4.2.6.1 & 4.2.6.2.
[57] KPMG response to the Remedies Notice, paragraphs 4.2.6.1 & 4.2.6.5.
[58] KPMG response to the Remedies Notice, paragraphs 4.2.6.1 & 4.2.6.6.
[59] KPMG response to the Remedies Notice, paragraphs 4.2.6.1 & 4.2.7.1.
[60] KPMG response to the Remedies Notice, paragraphs 4.2.6.1 & 4.2.8.2.
[61] KPMG response to the Remedies Notice, paragraph 4.2.9.1.

84. Finally, KPMG said that large multi-national companies were audited in several jurisdictions, and mandatory rotation in one would require international coordination, which was likely to be administratively burdensome and lead to substantial inefficiencies.[62] KPMG said that, in the case of multi-national companies, the CC had not set out whether mandatory rotation might apply to all components within a group or only to the holding company and Group audit.[63]

PwC

85. PwC said that the CC had not provided evidence that the current system of AEP rotation every five years was insufficient. PwC also said that a seamless transition between AEPs was not evidence of a lack of independence or insufficient professional scepticism.[64]

86. PwC said that by definition, mandatory rotation would always reduce the choice of audit firm available to companies by one. PwC said that in those sectors where there were recognized leading firms, companies would be forced to instruct lesser specialized firms, which could lead to a reduction in audit quality. PwC noted that the CC had found that the choice of audit firm was particularly limited in certain sectors including those where Mid Tier firms were not capable of conducting the audit.[65]

87. PwC said that the CC proposal that the FRC could, in certain circumstances, grant relief from the requirement to switch auditor would make the FRC the ultimate decision-maker in respect of audit appointments to a number of the UK's largest

[62] KPMG response to the Remedies Notice, paragraph 4.2.9.3.
[63] KPMG response to the Remedies Notice, paragraphs 4.2.6.1 & 4.2.8.3.
[64] PwC response to the Remedies Notice, paragraph 3.40.
[65] PwC response to the Remedies Notice, paragraph 3.42a.

companies—a role that it had not been established to perform and that it had expressed a reluctance to take on.[66]

88. PwC said that mandatory rotation would force companies to incur substantial switching costs associated with appointing a new audit firm and the loss of the benefits of continuity.[67]

Mid Tier firms

BDO

89. BDO said that it was opposed in principle to mandatory rotation. BDO said that academic studies had concluded that mandatory rotation was detrimental to audit quality and increased concentration in the audit market (as clients of Mid Tier firms rotate away from them to the Big Four, while clients of the Big Four rotate between the Big Four firms). BDO said that mandatory rotation also denied companies the right to make an informed choice to retain their present auditor.[68]

90. BDO said that mandatory rotation could force a company to change auditor despite having little choice of auditor, and that choice may be limited if it also used other audit firms for non-audit services, tax advice and/or due diligence advice.[69]

91. BDO recognized that there was pressure for rotation from some investors, and that mandatory rotation might be required under potential European legislation. BDO urged the CC to do adopt this only as a last resort, and said that mandatory tendering was preferable.[70]

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[66] PwC response to the Remedies Notice, paragraph 3.42b.
[67] PwC response to the Remedies Notice, paragraph 3.42c–3.44.
[68] BDO response to the Remedies Notice, paragraph 2.2.1.
[69] BDO response to the Remedies Notice, paragraph 2.2.2.
[70] BDO response to the Remedies Notice, paragraph 2.2.3.

92. BDO considered that any mandatory rotation should apply only after 20 years. BDO considered that if mandatory rotation were to take place only every 20 years there were unlikely to be many circumstances in which a company's choice of auditor was so restricted that it should not be subjected to mandatory rotation. Any exceptions should therefore be narrowly defined. Those exceptions could include: an opportunity for a company to delay the appointment of a successor firm for up to a year (with FRC consent) in the event of significant corporate activity, such as being the subject of a hostile takeover bid; and if the audit committee of a company genuinely believed that it had no option but to reappoint the incumbent auditor and it should be permitted to reappoint the incumbent for one additional term with the prior written approval of the FRC and a special resolution of shareholders in general meeting.[71]

93. BDO considered that the costs of mandatory rotation every 20 years would be: switching costs, including the management time involved in the education of a new auditor; and the loss to a company of continuing the relationship with its existing auditors even where that firm was considered by the company to be the best available choice of auditor.[72]

94. BDO considered that the benefits would include ensuring that auditors could not become entrenched indefinitely and that fresh eyes and fresh thinking would be brought in, which should help to reinforce auditor independence from executive management.[73]

Grant Thornton

95. GT said that it supported mandatory rotation as a measure to prevent complacency by audit firms in a market where audit tenures were excessively long and which

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[71] BDO response to the Remedies Notice, paragraph 2.3.1 & 2.4.
[72] BDO response to the Remedies Notice, paragraph 2.6.1.
[73] BDO response to the Remedies Notice, paragraph 2.6.2.

would bring about improvements in innovation, quality and price through increased competition. GT said that the measure would address the concerns of those investors who believed more frequent changes of auditor would take away perceptions of potential loss of independence which arise when an audit firm is in place for too long. GT said that while the current requirement for audit engagement partner rotation was an important safeguard for these concerns at the personal level, it did not address the perception that a familiarity threat arose between the company and the audit firm.[74]

96. GT said that a logical approach would be audit partner rotation at five years, mandatory tendering at a maximum of ten years and mandatory rotation after 15 years. GT said that the period of five years between tendering at ten years and rotation at 15 years, would provide the incumbent audit firm with significant motivation to continue as audit firm. That there was significant competition for one-off transactional non-audit assignments for fees far smaller than a potential five-year audit fee provided evidence that this would be the case.[75]

97. GT said that there was also merit in a mandatory rotation period of 20 years, which would still significantly increase the current switching rates in the FTSE 350, but that this was likely to be perceived as too long a period for an audit firm to remain appropriately independent in the context of a large listed company with a diverse shareholder base.[76]

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[74] GT response to the Remedies Notice, paragraphs 1.1 & 1.2.
[75] GT response to the Remedies Notice, paragraph 1.9.
[76] GT response to the Remedies Notice, paragraph 1.10.

98. GT said that 15-year rotation would limit disruption to the audit market and allow sufficient time for the benefits of an auditor's accumulated knowledge to be built up during the firm's tenure, before the perception of objectivity concerns arise.[77]

99. GT considered that the costs of the remedy would be minimal and likely to be overstated by those who opposed their introduction. On an appropriate timescale, the cost of changing auditor was unlikely to be unpalatably restrictive to large companies (and their investors). GT said that many investors would be willing to incur some additional costs where the value they perceived from the audit increased. GT said that any switch of service provider would incur a loss of familiarity and required certain investments on the part of both the service provider and the company.[78]

100. GT said that the most significant additional cost would fall upon audit firms in familiarizing themselves with a new company, and under current practice it was almost unanimously the case that audit firms 'absorb' these costs as an investment in the audited entity. GT believed that these costs should be ignored in considering the overall cost of implementation of this remedy.[79]

101. GT did not believe that MFR would reduce audit quality for the investor and had yet to see any reliable academic evidence that suggested it would. GT noted the CC finding that audit firms invested in an audit in the early years to avoid any adverse impact on quality which their unfamiliarity with the company might otherwise bring. GT said that in countries where MFR had been adopted had not resulted in evidence of a fall in audit quality.[80]

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[77] GT response to the Remedies Notice, paragraph 1.11.
[78] GT response to the Remedies Notice, paragraph 1.13.
[79] GT response to the Remedies Notice, paragraph 1.14.
[80] GT response to the Remedies Notice, paragraph 1.17.

102. GT said that there was often a significant benefit to the audit quality arising from switching in the sense that the new auditor might unearth issues previously unnoticed by the incumbent auditor, as new audit techniques brought a fresh approach, and a new firm was likely to be more sceptical because it started from a position where it had no preconceptions.[81]

103. GT said that any waiver system should be very closely drawn. GT considered that limited choice was to a degree self-inflicted, in that the company chose to award non-audit services to a potential alternative auditor when other firms would almost certainly have the capabilities to be able to provide those non-audit services. GT said that where companies had time to plan for a change in auditor both by getting to know a wider group of firms and by forward thinking with regard to providers of its non-audit services, and an accounting firm could plan to compete for audit and/or non-audit services over time, then the need for a waiver would disappear.[82]

Mazars

104. Mazars supported a mandatory rotation period of normally 15 years, subject to derogation or significant extension in the event a company appointed joint or major component auditors.[83] Mazars believed that it would be more appropriate for any waivers to come from the listing authority or BIS and should be exceptional and only permitted after all options had been explored, for example use of joint or major component auditors.[84]

105. Mazars said that there would be costs of 'educating' a new firm and additional costs to the firm in the first year of a new audit. It believed that the benefits would outweigh

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[81] GT response to the Remedies Notice, paragraph 1.18.
[82] GT response to the Remedies Notice, paragraphs 1.40 & 1.41.
[83] Mazars response to the Remedies Notice, section 10.
[84] Mazars response to the Remedies Notice, Appendix 1 34b.

the costs if tendering were linked to joint and major component audit as there would be significant benefits from having a vibrant competitive market.[85]

Kingston Smith

106. Kingston Smith did not support mandatory rotation. It did not agree that this would reduce barriers to involvement on non-Big-4 firms in the market. It believed that the remedy would damage the chances of wider competition as, given the views of some institutional investors, large listed companies usually switched to rather than from Big 4 firms. Mid Tier firms would be unlikely to wish to compete for audits in the reference market if they believed that they would not have a realistic chance of winning. It considered that if the remedy were to be implemented, a period of 20 years would at least mitigate to some extent the costs for business and loss of continuity and knowledge that would result from a short period.[86]

Crowe Clark Whitehall

107. CCW supported mandatory rotation at 20 years with ten years mandatory tendering, or 14 years with seven years mandatory tendering. CCW considered that a waiver should be available to allow for short-term circumstances where change in auditor would be severely disruptive. CCW said that the AC should be responsible for managing the transition and this should include ensuring that a choice of auditor was always available.[87]

Professor Dr Annette G Köhler[88]

108. Professor Dr Köhler said that the barriers to switching suppliers of audit services were caused by transaction costs prior to the choice of a transaction (both on the demand and supply side); and the nature of the service (eg experience good). Given

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[85] Mazars response to the Remedies Notice section 4 and appendix 34d.
[86] Kingston Smith response to the Remedies Notice, pp3 & 4.
[87] CWC response to the Remedies Notice.
[88] Prof Köhler response to the Remedies Notice.

these market characteristics, *ceteris paribus* long audit tenure was an efficient market solution.

109. The key question was whether audit quality varied with tenure. However, empirical evidence was mixed and therefore did not provide adequate evidence as to whether the costs related to auditor change would be outweighed by the benefits of a potential increase in audit quality. Professor Dr Kohler said that there might even be a decline in audit quality. From an economic perspective, *prima facie*, mandatory rotation could not be justified.

110. Prof Dr Köhler said that the lead to the question whether there were indirect beneficial effects of mandatory rotation. She said that in Germany there was clear empirical evidence on the effects of (voluntary) auditor change on the structure of the audit market for listed entities: audit market concentration increased by a shift of market share from non-Big-4 to Big 4 audit firms. Mandatory rotation might therefore have unintended negative consequences for the Non-Big-4 audit firms in the UK.

111. Professor Dr Köhler said that the competitive situation of auditors in a tender was always the same—irrespective of tenure limitation. Even if one assumed that auditors had misaligned incentives and competed to satisfy management rather than shareholders, there was no evidence that the imposition of restrictions on tenure would change these incentives.

UK industry bodies

Association of British Insurers

112. The ABI said that mandatory rotation would be likely to be costly and disruptive. ABI said that companies could be forced to change auditor at a time when the existing auditor's familiarity with the business would benefit the audit, such as when there is a

major acquisition or merger. ABI also said that it could also conceal the fact that an auditor had stood down for a particular reason and prevent auditors being reappointed when the preferred choice of both the Board and investors. The ABI said that ACs should be allowed, with appropriate shareholder engagement, to secure the best auditor for their business and this should not be artificially constrained.[89]

British Bankers Association

113. The BBA did not support mandatory rotation. It said that it was also aware that the corporate business world had expressed substantial reservations about mandatory rotation. BBA considered that it would be especially detrimental for the UK to proceed with such a measure if the rest of Europe decided that on balance it could not be justified.[90]

Chartered Financial Analyst Society of the UK[91]

114. The CFA said that it was divided on whether there should be a back-stop date for mandatory rotation. The reasons given for mandatory rotation were:

(a) without such a limit, one firm could continually audit a company for decades which could result in a cosy relationship leading to a lack of independence and scepticism;

(b) a new auditor would bring a fresh pair of eyes. Increased costs in year one can be mitigated and perhaps investors would not mind sanctioning a higher initial fee because of the benefit of fresh scrutiny; and

(c) auditors may be less likely to disagree with company management if there were no mandatory rotation and a tender was coming up. The auditor would not want to lose the business and might bend to the client's will to win the tender again.

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[89] ABI response to the the Remedies Notice.
[90] BBA response to the Remedies Notice.
[91] Chartered Financial Analysts Society response to the Remedies Notice.

115. The reasons given against were:

(a) the AC would not have the authority and flexibility to change auditor when it wanted to;

(b) the AC would not have a full choice of auditors to choose from as the incumbent auditor would not be able to rebid. A key concern was whether audit firms outside the Big Four would enter tenders for large company audits; and

(c) mandatory tendering would encourage competition in the audit market without the disadvantages of mechanical switching.

Chartered Institute of Management Accountants

116. The Institute did not agree with mandatory rotation. It said that there was no guarantee that the benefits of improved independence and objectivity that might result from changing audit firm would outweigh the costs of change. It believed that there was a high probability that a new auditor would have so much less specific, in depth experience and knowledge about the company that it would take years for the new auditor to duplicate the understanding that previously existed with the incumbent auditor. As a result, investors and the public would be less rather than more protected. It considered that rotation of audit firm should be at the discretion of audit committees.[92]

117. The Institute also believed that mandatory rotation may restrict competition in some market segments. Certain sectors required specialist auditing skills and experience and these were built up over a number of years of working in the particular industry. Mandatory rotation was likely to deter audit firms from making this investment and so reduce the effective choice available to audit committees.[93]

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[92] CIMA response to the Remedies Notice.
[93] CIMA response to the Remedies Notice.

Confederation of British Industry

118. The CBI did not support mandatory rotation as: businesses would incur increased costs; and it would have a detrimental impact on quality if the new auditor was forced on a company that was unfamiliar with the company particularly in periods of significant change. The CBI said that mandatory rotation would take power out of the hands of shareholders which would be a retrograde step. The CBI also said that the measure could reduce choice and competition as it would rule out the incumbent.[94]

GC 100[95]

119. The GC 100 did not support mandatory rotation of audit firms. It said that AC would wish to appoint the best firm for their company having conducted a formal tender process and if that happened to be the incumbent auditor, it made no sense to appoint an alternative given the length of time and resources required in the early years following a new appointment. The proposal also undermined the role of the AC which had developed hugely in recent years and which now was the dominant influence in tendering decisions.

120. The GC 100 said that many FTSE 350 clients may have a limited choice of audit firms. An auditor needed to have the expertise, experience, size and international scope required to handle the particular audit. In addition, a company would not wish to appoint an external auditor which provided extensive non-audit services for the company because of the need to retender the non-audit services currently provided by the new auditor, or had close links with a key member of financial management or the AC. In some cases, a company may also not wish to appoint an auditor which acted as auditor to a major competitor.

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[94] CBI response to the Remedies Notice.
[95] GC100 response to the Remedies Notice.

121. The GC 100 believed that mandatory rotation of audit firms diminished the authority of the Board to manage the company's affairs, and could undermine quality because of the lack of motivation in later years of the appointment and because it took time for a new auditor to get up to speed particularly in complex groups.

Institute of Chartered Accountants in England and Wales[96]

122. The ICAEW did not, on balance, support mandatory rotation as it would potentially limit choice for ACs by preventing them from choosing the firm they felt was best equipped to do the work, added to cost and caused practical difficulties without clear benefit. The Institute also said that while academic evidence was not wholly conclusive, it tended to suggest a negative effect on quality in the early years of an appointment.

123. The ICAEW said that the draft EC legislation included proposals on rotation and the EC's impact analysis suggested additional costs for public interest entities of between €10,000 and €67,000 each—excluding management time.

124. The ICAEW said that, if implemented, there might be some circumstances where a change at a given time would be inappropriate and it is suggested that the FRC should be able to grant relief. However, preclearance was not a process that the FRC or other regulators within the accountancy profession preferred to adopt. A better option would be to give guidance on the sort of circumstances that might be exceptional and allow temporary deferral, with full disclosure to shareholders, and an opportunity for them to disagree.

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[96] ICAEW response to the Remedies Notice.

Institute of Chartered Accountants of Scotland[97]

125. The ICAS said that it did not see the need for the CC to recommend the introduction of more frequent mandatory rotation of the audit firm at the present time.

126. The ICAS referred the CC to an independent literature review research paper undertaken on behalf of ICAS which examined all of the available research which had been carried out on mandatory audit firm rotation. The aim of the review was to identify, consider and evaluate the existing evidence on mandatory audit firm rotation to inform future policy making, highlight any deficiencies in the existing literature, identify opportunities for further research and make recommendations for policy makers. The review covered research from the major international markets and jurisdictions with experience of mandatory audit firm rotation. Issues considered included the impact, if any, of mandatory audit firm rotation on: audit quality, auditor independence, audit costs and audit market concentration.

127. The study also included a summary of the experiences of countries that have previously adopted a policy of mandatory audit firm rotation. The study found that the existing evidence on the impact that mandatory audit firm rotation has had on audit quality and auditor independence is inconclusive. The review highlights the need for more research looking at the implications of measures designed to improve audit quality and market concentration and a need to consider how audit quality can be measured by means other than the use of existing proxies.

128. The ICAS believed that the introduction of mandatory audit firm rotation would not necessarily increase the level of choice of auditors available to companies in the FTSE 350 audit market but rather might result in the work being redistributed among the Big 4 firms. The ICAS also said that mandatory rotation, to a certain extent,

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[97] ICAS response to the Remedies Notice.

removed the responsibility of the audit committee, to appoint their auditor of choice, for example if they would prefer to continue with the incumbent auditor at the time that they are due to be rotated.

129. The ICAS was not convinced that mandatory rotation would enhance audit quality. Its premise was that shareholders should have the right to appoint the audit firm, and there was already considerable change in a short period of time at a corporate entity—on average a Chief Executive and FD of a listed company in the UK change fairly frequently. Against the backdrop of changing executives, and also non-executives, it was not in the interests of shareholders to change auditors too often, as this had the negative result of losing the continuity and corporate memory that came with staying with the same firm.

130. The ICAS considered that orderly rotation every five/seven years within the team provided the best deal for shareholders, given that executive and non-executive directors were rotating faster than that, on average.

131. The ICAS said that mandatory rotation could have one of two effects in certain segments of the market: first, highly skilled teams could move between firms as the firms start to try to fill the gaps in their sector expertise. This could have the negative effect of making individuals more aligned with companies and less with the firms. Second, firms going into audit tenders with teams that did not have the deep sector experience as the incumbent firm.

132. The ICAS said that mandatory rotation might require rotation at a time which was inconvenient or even dangerous for the company, for example in circumstances where there were many other changes taking place in the company and/or its audit committee.

133. The ICAS also said that when changing auditor there were transition risks as there was a need in any switchover process to minimize the level of disruption to the company and the loss of knowledge and experience held by the auditor. Such risks should not be understated.

Institute of Management Accountants[98]

134. The IMA said that the majority of UK investors considered that imposing a requirement to rotate the auditor after a set period of time was undesirable. 'Mandatory rotation' could mean that companies were forced to change auditor at a time when the existing auditor's familiarity with the business would benefit the audit such as when there is a major acquisition or merger, or a change of senior management. It said that rotation could also conceal that an auditor had stood down for a particular reason and prevent an auditor being reappointed when they were the preferred choice of both management and investors.

135. The IMA said that it should be for a company, through its audit committee, to decide the best time to change auditor in consultation with its shareholders. Mandatory rotation disenfranchised both and in practice retendering should help achieve the greater level of rotation and refreshment that investors were seeking.

136. The IMA said that a significant minority of investors considered that companies should be required to rotate their auditor after 14 or 15 years. They considered a 'fresh pair of eyes' introduced a check on the incumbent audit firm's work, and ensured the audit was not unduly influenced by historical judgements and company management. The IMA said that the argument was that when an auditor had a longer tenure, it was likely to be less rigorous, since it had become familiar with the personnel and issues, and would not sufficiently question management judgements.

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[98] IMA response to the Remedies notice.

137. The IMA said that these investors did not, however, support mandatory rotation after seven or ten years as this could be costly and disruptive to companies. Moreover, there was likely to be a period of learning with any new assignment, at least for the first one or two years for major international groups, such that more frequent changes of auditor may not be in the best interests of investors and high quality audits.

138. The IMA agreed that if required the FRC should be able to grant a waiver. This would be particularly important at a time when the existing auditor's familiarity with the business would benefit the audit such as when there was a major acquisition or merger, or a change of senior management.

Hundred Group of Financial Directors

139. The Hundred Group of Financial Directors said that mandatory rotation would further increase concentration by removing the incumbent from the small number of competitors.[99]

International Federation of Accountants[100]

140. IFAC did not support mandatory rotation because there was not sufficient evidence that it would have a positive impact on auditor independence and audit quality, and that the benefits would outweigh the risks and costs. IFAC also said that the impacts on audit quality of the audit engagement partner rotation requirement, introduced no more than a decade ago, had yet to be properly assessed.

141. IFAC said that with mandatory rotation companies might move their audit service requirements between Big 4 firms which would have no impact on the barriers to entry that were perceived to exist between the Big 4 firms and other firms.

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[99] FD 100 Group response to the Remedies Notice.
[100] International Federation of Accountants response to the Remedies Notice.

UK Shareholders' Association[101]

142. The UK Shareholders' Association strongly agreed with the USS proposal that there should be a maximum tenure period for the holding of audit appointments. The advantage of this would be a completely new pair of eyes. It said that there was no acceptable substitute for this.

143. It said that partner rotation did not provide a reliably fresh approach given the very reasonable policy of audit firms to ensure that any contentious points on an audit were referred to their technical departments. It was also very difficult for a member of a firm to challenge the decisions of his predecessors. There should not be a waiver as auditors and audit committees should be able to plan for and manage any required changes.

Non-UK bodies

Canadian Public Accounting Board—Enhancing Audit Quality Steering Group[102]

144. The Canadian Public Accounting Board was concerned that mandatory rotation would have unintended consequences leading to diminishing audit quality and undermining the role of the audit committee.

145. It said that while certain jurisdictions around the world had adopted mandatory rotation (and/or mandatory tendering regime), it was not aware of compelling evidence that this policy had led to improved audit quality and its understanding was that it may have led to a substantial reduction in audit fees in some jurisdictions. The CPAB said that mandatory rotation might lead to increased price competition and that audit would become a commodity to be differentiated on price and not quality.

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[101] UK Shareholders' Association response to the Remedies Notice.
[102] Canadian Public Accountability Board response to the Remedies Notice.

146. The CPAB said that mandatory rotation might limit choice in specialized industries thereby negatively impacting audit quality. In circumstances where a non-auditor firm was providing substantial consulting services to a company it might not be willing to forego this work to become the auditor, thereby actually reducing the potential choices to only one or two others. The CPAB said that such limited choice could lead to reduced audit quality in the longer term.

147. It agreed that there was a risk that, after an extended period of time, audit firms could develop a close relationship with their clients that could potentially affect the firms' independence and, ultimately, their ability to exercise appropriate scepticism. In 2012, in collaboration with the Canadian Institute of Chartered Accountants, it launched the Enhancing Audit Quality Initiative (EAQ) and formed working groups to explore ways in which audit quality could be enhanced in three key areas: auditor independence; the role of the audit committee; and auditor reporting.

148. The key recommendation of both the EAQ Independence and Audit Committee working groups to address the threat of institutional independence and enhance auditor professional scepticism was for the AC to enhance its oversight of the work of the external auditor and perform a Mandatory Comprehensive Review.

Confederation of Swedish Enterprise and Institute for the Accountancy Profession in Sweden[103]

149. These bodies said that shareholder involvement in the appointment and dismissal of a company's auditor should be strong and that it was the fundamental right of the owners to make the decisions in the process of evaluating and appointing the auditor. They considered that there were other more efficient ways of getting shareholders engaged than by mandatory firm rotation in particular the continued development of

[103] Confederation of Swedish Enterprise and Institute for the Accountancy Profession in Sweden response to the Remedies Notice.

Nomination Committees. They were also not aware of analyses or international experiences that showed mandatory tendering increased competition within the audit market for larger entities.

Hong Kong Institute of Certified Public Accountants

150. The Hong Kong Institute of Certified Public Accountants did not believe that there was evidence to show that mandatory rotation of audit firm would have a positive effect on audit quality or in opening the market for more participants to provide audit services to large companies. It should be for a strong and effective audit committee to appropriate action to ensure the company and shareholders receive a quality audit at a fair cost.[104]

Institute of Chartered Accounts Australia

151. The Institute of Chartered Accountants Australia considered that a measure such as mandatory rotation should be proposed only if there was unequivocal evidence on the need and benefit which could not be catered for through other means. It said that ACs were charged with the oversight and review of the external audit and were well placed to assess the effectiveness of the audit and the appropriateness of their reappointment.[105]

South African Institute of Chartered Accountants

152. The Institute said that with mandatory rotation the knowledge and understanding acquired by that firm would be lost along with the efficiencies that could be passed on from year to year which could be argued to affect audit quality. We also think it undermines extending accountability of the auditor to the audit committee if the audit

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[104] Hong Kong Institute of CPA response to the Remedies Notice.
[105] Institute of Chartered Accountants Australia response to the Remedies Notice.

committee is precluded from potentially choosing the firm they think is best for the job.[106]

Individuals

153. Simon Laffin is a qualified accountant with experience as Board and Audit Committee member over the last 19 years. He is currently the chairman of a listed UK company and chairman of the audit committee for two UK listed companies, and had been the CFO of a FTSE 100 company and served as audit committee chairman on two other significant listed companies.[107]

154. He said that mandatory rotation seemed unnecessarily intrusive if retendering were already prescribed. Given that for many companies, a Big 4 firm was the only practical choice, mandatory rotation would rule out the incumbent, reducing effective choice to three. Furthermore, it was quite likely that two of the Big 4 would already be providing transaction and tax advice, so mandatory rotation would in many cases force a change to a predetermined firm. Mandatory rotation would, by definition, reduce choice for boards, which would seem a counterintuitive remedy for a competition authority to argue.

155. He said that if shareholders wished mandatory rotation, they had it easily in their powers to mandate their boards to do this. The case that the CC should substitute its judgement for that of shareholders seemed not to be justified. The ultimate decision on the timing of a change in auditor should always rest with boards that are directly responsible to and elected by shareholders.

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[106] South African Institute of Chartered Accountants response to the Remedies Notice.
[107] Mr Laffin's response to the Remedies Notice.

Parties' views on restrictions of NAS

1. This appendix sets outs the views of parties on the possible restriction of audit firms providing NAS to audit clients.

2. The views are grouped thematically based on the views expressed by parties:

   (a) Support for further restrictions on provision of NAS:

   (i) encouragement of greater focus on the audit;

   (ii) independence and reputational issues;

   (iii) gaining exposure for Mid Tier firms; and

   (iv) effective restriction on switching auditor.

   (b) Ways of restricting NAS.

   (c) Support for total prohibition.

   (d) Other restrictions of NAS.

   (e) Challenging the effectiveness of the remedy in addressing the AEC.

Support for further restrictions on provision of NAS

3. A number of parties expressed disappointment that the CC was not considering further restrictions on the provision of NAS by the auditor. These parties were broadly Mid Tier firms, investors and some individuals including ACCs. Their views are set out in the following sections.

4. There were four main themes in the points raised by those parties which supported further regulation of NAS: *(a)* encouragement of greater focus on the audit; *(b)* independence and reputational issues, *(c)* gaining exposure for Mid Tier firms, and *(d)* effective restriction on switching auditors, as we set out below.

Encouragement of greater focus on the audit

5. The ACC of Company G considered that the FRC had not gone far enough in restricting the provision of NAS by the auditor to a company and further movement in this direction would direct the audit firm's focus on audit.[1] BDO encouraged the CC to explore the effects of the provision of such services on audit quality and concentration, which BDO considered to be substantial.[2]

6. Several respondents to the Remedies Notice supported this claim by drawing attention to what they claimed were disproportionately high fees auditors of companies were receiving for NAS to those companies. GT said that its research into corporate reporting within the FTSE 350, 'A Changing Climate, Fresh Challenges Ahead', indicated that companies in the FTSE 350 incurred on average non-audit fees of 80 per cent of their audit fees in the period from May 2010 to April 2011 and, of these, 73 companies paid more to their auditor for NAS than for audit services. The report also showed that only ten companies did not use their auditor to provide any NAS during the period of review.[3]

7. Mazars noted that many investors had called for a 50 per cent cap. At present seven companies in the FTSE 100 had NAS that exceeded the audit fee, as did 39 FTSE 250 companies, 20 of which had NAS fees above twice the level of the audit fee.[4]

8. Group A firms provided more detail: the value of NAS fees of 30 FTSE 100 and 83 FTSE 250 (approximately one-third) companies paid to their auditor was greater than

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[1] Case Study G, paragraph 15.
[2] BDO response to the Remedies Notice, 18 March 2013.
[3] GT response to the Remedies Notice, 18 March 2013.
[4] Mazars response to the Remedies Notice, 19 March 2013.

half of the statutory audit fee, and the NAS fees of 72 FTSE 350 companies exceeded 70 per cent of the audit fee.[5]

Independence and reputational issues

9. GT expressed concern over the risk that the use by companies of the auditor for the provision of many NAS created further concerns over the independence of the auditor and the familiarity of the auditor with management.[6] Several respondents made similar points with respect to concerns over independence, objectivity and familiarity:

   (a) Mazars wrote that NAS not related to the audit could naturally pose a threat to the auditor's independence, at least the perception of it. This was valid even if individual NAS were deemed acceptable for the auditor to undertake.[7]

   (b) A coalition of eight institutional investors in the UK believed that the prospect of winning lucrative non-audit contracts posed a potential conflict of interest for incumbent audit firms.[8]

   (c) The IMA wrote that 'audit should be the key service and when the fees for non-audit services are significantly more than the fees for the audit, independence and objectivity can be compromised.'[9]

10. The perception of non-independence, some respondents stressed, clearly carried reputational risks for auditors. Mr Nick Land, the ACC for four major multinational companies, said that the continuing practice of awarding an auditor some NAS, eg tax, damaged the image of the audit industry and the perception of independence.[10]

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[5] Group A response to the Remedies Notice, 4 April 2013.
[6] GT response to the provisional findings, 25 March 2013.
[7] Mazars response to the Remedies Notice, 19 March 2013.
[8] USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (representing 56 pension funds), London Pensions Fund Authority, Governance for Owners, Environment Agency Active Pension Fund response to the Remedies Notice, 19 March 2013.
[9] IMA response to the provisional findings and Remedies Notice, 25 March, 2013.
[10] Meeting with Mr Nick Land, 21 June 2013, paragraph 4.

11. L&G cited the example of Arthur Andersen which had failed to maintain its authenticity in conducting audits for its clients, whilst trying to expand its consultancy service offerings and maximize profits. L&G said that this catastrophically led to damage in reputation, loss in confidence and the collapse of one of the biggest audit firms in the world which was once one of the 'Big 5'.

12. Noting that we argued in our provisional findings that there was no clear evidence that non-audit work was more profitable than audit work, L&G still saw a risk that such services could impair the independence of audit. L&G stated that services like consultancy work might start of on a small scale but develop to a larger amount and that this could possibly add to the retention of the incumbent audit firm and reduce the bargaining power of companies to change their auditors. L&G noted in particular that, although they understood that audit work was more standardized, depending on the company itself, it was still possible that non-audit work could be on a large scale and vastly exceed audit work. L&G believed that this in itself posed a risk to auditor independence and integrity: 'As shareholders, we have seen non-audit fees as a percentage increase in size.'[11]

13. The UK Shareholders' Association wrote that it appreciated the arguments for not restricting this type of work and that whilst it might or might not be true that non-audit work was more profitable than audit work, it was, however, additional work and therefore attractive.[12]

Gaining exposure for Mid Tier firms

14. The UK Shareholders' Association noted that a restriction on the total value of work that could be undertaken by the incumbent audit firm would not prevent the use of other firms where appropriate and that such a restriction would allow non-incumbent

[11] L&G response to the Remedies Notice, 20 March 2013.
[12] UK Shareholders' Association response to the Remedies Notice, 20 March 2013.

firms the opportunity to gain exposure to the company being audited and become potential candidates to take over when tenure expired.[13]

15. Encouraging companies to make a wider selection of firms to undertake NAS could, as CCW said, for example, increase the exposure and experience companies had of firms outside the Big 4 which could over time lead to gaining greater confidence and assurance in their abilities.[14]

16. The ACC of Company G said that further restrictions on the provision of NAS by the auditor would enable firms other than the auditor to establish relationships with companies and to give the other firms the opportunities to develop the right skills for working with the sector concerned, eg with bankers.[15]

17. The Group A firms said that non-Big-4 firms needed opportunities to get to know FTSE 350 companies better, and to allow management to build confidence in them, by working with them on non-audit issues.[16]

18. GT commented that the current scenario resulted in an environment where it was very difficult for firms outside of the auditor to build relationships and raise their profile with the company—in many cases with non-audit work being allocated to the auditor without consideration of other firms. Additional restrictions over NAS would act as a powerful measure to break down barriers to entry to the market for firm outside the largest four audit firms.[17]

19. However, two respondents, BDO and Nick Land, doubted that NAS represented a significant way into large company audits for Mid Tier firms. BDO was sceptical given

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[13] ibid.
[14] CCW response to the Remedies Notice, 18 March 2013.
[15] Case Study G, paragraph 15.
[16] Group A response to the Remedies Notice, 4 April 2013.
[17] GT response to the Remedies Notice, 18 March 2013.

the differences in the people making the purchasing decisions in the companies concerned and the different criteria on which they did so for different services.[18] Nick Land believed there was little chance that second-tier firms could develop to challenge the listed audit practices of the Big 4 firms without a massive global shake-up.[19]

Effective restriction on switching auditors

20. CCW did not believe that the summary of provisional findings explored sufficiently the limitation of choice created by the use of the Big 4 in the provision of audit and NAS to the FTSE 350 companies. Where different Big 4 firms were appointed to provide audit and NAS, this could provide a limitation on the choice available to ACs when seeking to change auditor due to issues of independence and conflict. It believed that ACs and management should be given every encouragement to consider a wider range of the firms they considered for the provision of both audit and NAS beyond the Big 4.[20]

21. The ACC of Company W, for example, was concerned that all of the Big 4 provided extensive consultancy services to the industry which meant that there was always a risk of firms being conflicted out.[21]

Ways of restricting NAS

22. Several respondents (GT,[22] the IMA,[23] IFAC[24] and a consortium of eight institutional investors[25]) noted that there were already some restrictions on the types of NAS auditors could supply.

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[18] BDO response to the Remedies Notice, 18 March 2013.
[19] Meeting with Mr Nick Land, 21 June 2013, paragraph 30. Mr Land argued: 'The emergence of the former Big 8, now a Big 4, had been market-driven. In the seventies and eighties, so as to meet the needs of major multinational clients, they had merged with many of the best national firms around the world. It was now too late for the second tier firms to take a similar route. Mr Land nonetheless agreed that the greater number of new tenders could stimulate some efforts by these firms to expand their capabilities, but he doubted the dominance of the Big 4 would be significantly eroded.'
[20] CCW response to the Remedies Notice, 18 March 2013.
[21] Company W, paragraph 35.

23. GT explained: the UK listed audit market currently followed the Ethics Standards issued by the Auditing Practices Board which built on the IFAC code of ethics and which stipulated various requirements regarding the provision of NAS by the auditor. These ethical rules prohibited the provision of certain NAS in addition to setting parameters over the size and type of fees which were able to be charged. In many cases arenas were able to be provided by the auditor if appropriate safeguards were applied and the AC gave agreement to the service provision.[26]

24. The case studies of companies we conducted confirmed that the ACs of many companies had published rules relating to the percentage of their total fees that auditors could earn from NAS.

25. It was also noted by GT and BHP Billiton that multinational companies' choice of auditors might be restricted by regulation, such as the Sarbanes-Oxley Act in the USA, which restricted the provision of certain types of NAS by auditors.[27] The Chartered Professional Accountants of Canada pointed out that there were provisions in Canada on certain NAS.[28]

26. Kingston Smith was pleased that the CC was not considering any further restrictions on the provision of NAS by the auditor. An effective and established system of checks and balances on the provision of such services already existed in the form of

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[22] GT response to the Remedies Notice, 18 March 2013.
[23] IMA response to the provisional findings and Remedies Notice, 25 March, 2013.
[24] IFAC response to the Remedies Notice, 18 March 2013.
[25] USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (representing 56 pension funds), London Pensions Fund Authority, Governance for Owners, Environment Agency Active Pension Fund response to the Remedies Notice, 19 March 2013.
[26] GT response to the Remedies Notice, 18 March 2013.
[27] GT response to the provisional findings, 25 March 2013.
BHP Billiton plc response to the Remedies Notice, 15 March 2013.
[28] Chartered Accountants of Canada and Canadian Public Accountability Board, 18 March 2013.

Ethical Standards for Auditors and was, in its view, working well in dealing with actual, potential or perceived conflicts of interest or independence issues.[29]

27. However, many other respondents argued that, despite the current restrictions, auditors continued to win a disproportionate share of non-audit contracts (see paragraph 6, above). A consortium of eight institutional investors, for example, said it appreciated that there were already guidelines around 'black-listed' NAS that auditors should not engage in. However, it considered any non-audit work as generating perverse incentives for the audit firm, and for this reason proposed an across-the-board limit.[30]

28. The restrictions proposed by parties ranged from total prohibition to the setting of prescriptions to limit the types or nature of NAS an auditor could provide.

Support for total prohibition

29. Nick Land believed there should be a total prohibition to avoid any perception of a loss of independence.[31] Mr Tony Shearer said similarly that the CC should require firms that sought to audit the accounts of 'major businesses' to ensure that their focus was on audit and to do this the CC should require those firms to divest themselves of all NAS.[32]

Support for the restriction of NAS

30. GT would like to see greater restrictions on the provision of certain types of NAS and/or limiting the aggregate level of such services that were able to be provided to

[29] Kingston Smith response to the provisional findings, 1 March 2013.
[30] USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (representing 56 pension funds), London Pensions Fund Authority, Governance for Owners, Environment Agency Active Pension Fund response to the Remedies Notice, 19 March 2013.
[31] Meeting with Mr Nick Land, 21 June 2013, paragraph 28.
[32] Tony Shearer, submission on the provisional findings, 17 April 2013.

FTSE 350 companies by the incumbent audit firm.[33] Both types of restrictions had their supporters among the parties.

31. Those arguing for a limitation of the aggregate level of NAS—most advocated a 50 per cent cap—included the Group A firms (which wanted to see this implemented through amendments to the IFAC/IESBA code)—L&G, the UK Shareholders' Association, and a consortium of eight institutional investors.[34]

32. BlackRock, for example, argued that certain services for audit clients should be proscribed under all conditions including those that could impair, or have the appearance of impairing auditor independence—including bookkeeping related to audit clients' accounting records or financial statements, appraisal or valuation services, actuarial services and others, including human resources and legal services. Additionally, any contingent fee arrangements for audit or non-audit services should not be permitted for an audit client.[35]

33. GT argued for the inclusion of both types of restrictions in the CC remedies package, considering this to be a low-cost measure to changing buying patterns in the market, as the remedy essentially replaced one supplier with another in markets where there were ample suppliers.[36]

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[33] GT response to the Remedies Notice, 18 March 2013.
[34] Group A response to the Remedies Notice, 4 April 2013; Legal and General Investment Management response to the Remedies Notice, 20 March 2013; UK Shareholders Association response to the Remedies Notice, 20 March 2013; USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (representing 56 pension funds), London Pensions Fund Authority, Governance for Owners, Environment Agency Active Pension Fund response to the Remedies Notice, 19 March 2013.
[35] BlackRock response to the Remedies Notice, 18 March 2013.
[36] GT response to the Remedies Notice, 18 March 2013.

Effectiveness of remedy in addressing the AEC

34. The Big 4 audit firms generally registered agreement with our provisional decision, without elaboration. Deloitte, however, provided a fuller critique of any proposed remedy to constrain NAS provision by the auditor.

35. Deloitte[37] stated that there was no aspect of the AEC identified in the provisional findings which would be addressed by a remedy to restrict NAS and agreed with the analysis presented in the Remedies Notice.[38] Deloitte concluded that given the lack of effectiveness, the remedy would necessarily be disproportionate. Deloitte noted that the Audit Practice Board in 2010 concluded that companies continued to value the ability to select their auditor for the provision of appropriate NAS, subject to appropriate constraints.[39]

36. Deloitte listed the following factors that should be borne in mind with respect of any further restriction on the provision of NAS:[40]

(a) effective regulatory measures were already in place in relation to the provision of NAS by an auditor;

(b) firms had effective rules in place to maintain audit independence in the context of NAS provision;

(c) companies nowadays strongly policed NAS provision by their auditor; and

(d) such a remedy would also give rise to multiple additional costs and distortions:

(i) it would run the risk of reducing the competitor set for audit and/or NAS;

(ii) it could prevent companies selecting the most appropriate provider of audit services or NAS, with appropriate independence protections carefully respected; and

[37] Deloitte response to the Remedies Notice, 18 March 2013.
[38] ibid, paragraph 10.2.
[39] ibid, paragraph 10.3.
[40] ibid, paragraph 10.3.

(iii) it might deprive companies of enhanced insights gained from the audit which were of relevance in their wider business.