

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Provisional decision on remedies

Notified: 22 July 2013

The Competition Commission has excluded from this published version of the provisional decision on remedies information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. Some numbers have been replaced by a range. These are shown in square brackets.

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Summary

1. On 21 October 2011 the Office of Fair Trading (OFT) referred statutory audit services to large companies¹ in the UK to the Competition Commission (CC) for investigation under section 131 of the Enterprise Act 2002 (the 2002 Act).

2. On 26 February 2013 we issued our provisional findings report (provisional findings) in which we provisionally found an adverse effect on competition (AEC) arising from features preventing, restricting or distorting competition in the market for statutory audit services to large companies. Simultaneously with our provisional findings we issued a Notice of Possible Remedies (the Remedies Notice), which invited comments on the actions we might take, or recommend for others to take, to remedy, mitigate or prevent the AEC, or resulting detrimental effects on customers. On 5 June 2013 we published a Notice of supplementary remedies proposing a competition duty for the Financial Reporting Council (FRC).

3. This document presents our provisional decision on the package of remedies we think is required to remedy the AEC and resulting customer detriment. In reaching our provisional decision we have taken into account responses to the Remedies Notices, hearings and meetings, further submissions, and further analysis that we have conducted.

4. The main aspects of the remedy package that we have provisionally decided on are as follows:
 - (a) FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. Companies may defer this obligation by up to two years if there are exceptional circumstances. There will also be a transitional period of five years before our tendering requirements come into full effect.

¹ 'Large companies' means companies that may from time to time be listed on the London FTSE 100 and FTSE 250 indices.

- (b) The Audit Quality Review (AQR) team should review every audit engagement in the FTSE 350 on average every five years. The Audit Committee (AC) should report to shareholders on the findings of any AQR team report concluded on its company during the reporting period, stating the grade awarded and how both the AC and auditor are responding to the findings.
 - (c) The AQR team should review and report on the larger Mid Tier firms on an annual basis.
 - (d) Provisions in loan agreements which restrict a company's choice of auditor to certain categories or lists of statutory auditors should be prohibited.
 - (e) An advisory vote should be introduced on the sufficiency of the disclosures in the Audit Committee report section of the Annual Report (the Audit Committee Report); and amendments to the UK Corporate Governance Code and Stewardship Code made to further encourage shareholder engagement.
 - (f) Measures should be introduced to strengthen the accountability of the external auditor to the AC, including a stipulation that only the AC is permitted to negotiate and agree audit fees and the scope of audit work, initiate tender processes and make recommendations for appointment of auditors and authorize the external audit firm to carry out non-audit services (NAS).
 - (g) The FRC should amend its articles of association to include a secondary objective to have due regard to competition.
5. The remedy package includes measures to improve the bargaining position of companies and encourage rivalry among audit firms; measures to enhance the influence of the AC in a company's relationship with its external auditors; and measures to promote shareholder engagement in the audit process. These remedies work in combination to promote competition and to ensure that competition is directed towards satisfying the demands of shareholders.

6. We consider that putting the statutory audit engagement out to tender more frequently will improve rivalry by ensuring that regular and well-informed assessments are made of whether a company's audit service is competitive. We found that tenders were thorough, fair, and transparent processes in which the AC had an influential role, ensuring that shareholder interests are given appropriate weight and which strengthen the incentives of audit firms to offer a competitive product.

7. We consider it to be a matter of judgement as to the appropriate interval between tender processes. We note the Financial Reporting Council's (FRC's) judgement that five years was the appropriate interval for rotation of an Audit Engagement Partner (AEP) to ensure their objectivity and independence and saw no grounds to alter it. We were persuaded of the benefits of aligning the interval between tender processes with AEP rotation, as this provides a break in the audit relationship at which the AC can make an informed choice of audit partner, and if it wants, switch audit firm without incurring more disruption than is necessary, and would limit the advantage that the incumbent firm derives from being able to offer an AEP with pre-existing experience of the company. This led us to choose between periods of five or ten years.

8. We think ten years too long a time for an audit engagement not to be subject to the high level of scrutiny and competition that that we found takes place within a rigorous tender process. In addition, and in line with the FRC's judgement that five years is the appropriate period for the safeguarding of objectivity and independence, we consider that a period of five years would best ensure the sustained alignment of auditor incentives with shareholder (rather than management) demand. We do not consider from a competition perspective that an intra-firm partner rotation adequately secures this position. While partner rotation plays a legitimate role in ensuring that individual audit partners are objective and independent, it does not disturb the

economic incentives of the audit firm and it is those firm-level incentives that our analysis is primarily concerned with.

9. Our provisional view is that five years is an appropriate interval at which to subject the audit relationship to scrutiny and challenge, and that going out to tender at this interval will increase company bargaining power and ensure a competitive service between tender processes. We think that companies should have an opportunity to defer going out to tender by up to two years where there are exceptional reasons to do so.
10. The AC is an important part of the corporate governance architecture, and we place weight on its role in ensuring that competition takes place to satisfy the demands of shareholders. We consider that going out to tender on a regular basis will enhance the influence of the AC in the selection of the external auditor. We have provisionally decided to take further steps to increase the influence of the AC in the relationship with the external auditors. These steps include: enhancing the accountability of the auditor to the AC and enhancing the accountability of the AC to shareholders. The increased influence of the AC in combination with more frequent tender processes should help to ensure that competitive outcomes are achieved and that shareholders can be more confident that their interests have been at the forefront of any tender process and subsequent appointment decision, as well as throughout the ensuing audit relationship.
11. Information is important to the ability of shareholders to hold ACs to account in representing their interests, and our remedies in this area reinforce the FRC's recent changes to the Audit Committee Report and to ISA 700 to encourage greater disclosure by ACs and auditors. We have provisionally decided to require the AC to report on the results of any AQR during the period and to require companies to hold

an advisory vote on sufficiency of the disclosures in the Audit Committee Report. We consider that these measures will encourage meaningful disclosure, promote high-quality audit, and enable shareholders to better appraise the effectiveness of the AC.

12. In designing an effective package of remedies, we have sought to ensure that the measures work in combination to produce the necessary incentives to ensure that competition works well. Our remedies designed to increase AC influence will work in combination with more frequent tender processes to ensure that competition is better focused on shareholder demand. Our remedy package will also promote information flow between companies and investors in relation to external audit and thus allow ACs to understand shareholder concerns better, and so better act on them.
13. We consider that our package of remedies is likely to increase choice, as both Big 4 and Mid Tier firms will have increased incentives to develop and expand their capabilities in order to win engagements. We consider that measures to prohibit restrictions on auditor appointment in loan agreements, in combination with more frequent tender opportunities, will encourage firms outside the Big 4 to invest in the capabilities necessary to win FTSE 350 engagements, particularly those lower down the scale of complexity and international breadth.
14. We have considered the role of the FRC carefully in formulating our remedy proposals, and we note that it has evolved over time into an agency that is increasingly well equipped to provide high-quality independent regulation to the audit market. We found that the work of the AQR team was well regarded, considered carefully by audit firms and companies, and so we found that it had an important role in promoting competition between audit firms. We welcomed the recent changes to the UK Corporate Governance Code to increase tendering and expand AC reporting,

and changes to ISA 700 to expand auditor reporting, as we see them as beneficial steps towards promoting competition.

15. However, we considered that further steps were required to increase the resources of the AQR team, and to encourage transparency of AQR grades. We considered that a change to the FRC's objects to have due regard to competition would ensure that it places appropriate weight on the role of competition in facilitating high-quality audit. We would necessarily be reliant on the FRC to take our recommendations forward, and to ensure that it secures the appropriate funding to facilitate this. In doing so we consider that the FRC will further strengthen its role as an accountable, transparent, and independent regulator of the audit industry.
16. We expect that the above measures taken together as a package will be effective and proportionate in remedying the AEC. We expect this remedy package to result in a substantially improved environment for competition in the FTSE 350 statutory audit market.
17. We are minded not to pursue the following remedies:
 - (a) Mandatory switching.
 - (b) Further constraining NAS provision by the auditor.
 - (c) Joint or major component audit.
 - (d) Shareholder group or FRC responsibility for auditor reappointment.
 - (e) Independently resourced Risk and AC.
18. We gave careful consideration to whether mandatory switching should be introduced. Our provisional view is that while mandatory switching would address concerns expressed by investors about very long tenures, our proposed remedy package addresses the AEC more effectively whilst delivering similar benefits and avoiding

some of the costs associated with mandatory switching, and in particular the weakening of competition that would result from the incumbent firm being systematically excluded from the tender process. As a result, we have provisionally decided not to impose mandatory switching as a remedy to the AEC that we have provisionally found.

19. We have also decided against introducing measures to further constrain NAS, to further encourage or mandate joint/shared audit provision, to provide for shareholder or FRC appointment of auditors, and to establish an independently resourced Risk and AC. We decided that including any of these measures in our proposed remedy package would not add significantly to its effectiveness in addressing the AEC that we have found, and may add to the costs incurred.

20. We accept that the measures we are prescribing impose some additional costs, in particular on companies and on firms which we estimate to be less than £30 million per year in total when our tendering requirements come into full effect, and considerably lower in the initial five-year transitional period. These are small sums in relation to the combined market capitalization of the FTSE 350. On the other hand we consider that the benefits of our proposed remedy package are considerable. In our judgement, we think that an increase in competition and a refocusing of competition towards shareholder demand should increase audit quality and have important beneficial effects on shareholder value. We place considerable weight on the public benefits for the UK economy. An audit market in which shareholders can have increased confidence will assist in promoting the UK's corporate governance regime as a centre of excellence and will encourage investment in UK companies. It is not feasible to quantify the size of such benefits with precision, however, in our considered judgement, they are likely to exceed the costs of our remedy package by a substantial margin.

21. In view of the above considerations, we have provisionally decided that our proposed package of measures represents as comprehensive a solution as is reasonable and practicable to the AEC and resulting customer detriment that we have provisionally found.
22. We invite views in writing on the provisional decision on remedies and its underlying analysis by Tuesday 13 August 2013. These should be emailed to: auditors@cc.gsi.gov.uk or sent to:
- Inquiry Manager
Audit Market Investigation
Competition Commission
Victoria House
Southampton Row
LONDON
WC1B 4AD
23. This provisional decision on remedies is based on the AEC that we have provisionally found. We are continuing to consider the nature of the AEC and resulting consumer detriment, and will incorporate our views in our final report.

Provisional decision on remedies

1. Introduction

- 1.1 In our provisional findings, published on 22 February 2013, we concluded that features of the relevant market prevented, restricted or distorted competition and that these gave rise to an AEC within the meaning of section 134(2) of the Act.

- 1.2 We published a Remedies Notice with the provisional findings and a Notice of a further possible remedy on 5 June 2013. We received 58 responses to the Remedies Notice and Notice of a further possible remedy. In addition, we held 13 response hearings with audit firms, companies, investors, and the FRC. Non-confidential versions of [responses to the Remedies Notice](#), [Notice of a further possible remedy](#), and [summaries of response hearings](#) can be found on our website. We also issued a questionnaire to investors and conducted a series of case study interviews with Chief Financial Officers (CFOs) and Audit Committee Chairs (ACCs), [summaries of which are published on our website](#). We have considered carefully all the evidence we have received.

- 1.3 We have made a provisional decision as to the package of remedies that we consider would be effective and proportionate in addressing the AEC and any detrimental effect on customers resulting, or expected to result, from the AEC that we provisionally identified. This document sets out this proposed package of remedies and our reasons for selecting it.

The legal framework for consideration of remedies and relevant customer benefits

1.4 If the CC has found that there are features of the statutory audit market that give rise to an AEC, it is required to decide the following additional questions:²

- (a) Whether action should be taken by the CC for the purpose of remedying, mitigating, or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition.
- (b) Whether the CC should recommend the taking of action by others for the purpose of remedying, mitigating, or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition.
- (c) In either case, if action should be taken, what actions should be taken and what is to be remedied, mitigated, or prevented.

1.5 A detrimental effect on customers includes such an effect on future customers and is defined as one taking the form of:³

- (a) higher prices, lower quality, or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or
- (b) less innovation in relation to such goods and services.

1.6 Whether such action should be taken involves consideration both of the action the CC can take and action the CC can recommend others to take. In either case, the CC will state the action that should be taken and what it is designed to address. In practice, the CC may decide to take several discrete actions itself and/or make

² Section 134(4).

³ Section 134(5).

several discrete recommendations. This combination of measures is referred to as a package of remedies.

1.7 The Act requires the CC, in considering these questions:

In particular to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition and any detrimental effects on customers so far as resulting from the adverse effect on competition.⁴

1.8 In deciding the question of remedies, the CC may also in particular 'have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned'.⁵

1.9 When deciding on an appropriate remedy, the CC will have regard to the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality.⁶

The AEC and resulting customer detriment

1.10 In this section we summarize the nature of the AEC and the resulting customer detriment that we have provisionally identified. In particular we summarize:

(a) the nature of the AEC as set out in our provisional findings (see paragraph 1.12);

and

(b) our assessment of the customer detriment that results from the AEC (see paragraph 1.15).

⁴ [Section 134\(6\)](#).

⁵ [Section 134\(7\)](#).

⁶ See CC3 (Revised), *Guidelines for market investigations: Their role, procedures, assessment and remedies*, paragraph [329](#).

1.11 We have not at this stage made a final decision regarding the existence and form of any AEC and/or resulting customer detriment. We have based this document on our provisional findings, and it aims to address the AECs that the provisional findings identified. We consider in this document recent actions by the FRC that may affect competitive conditions in the market. Our final decision on any AEC, and appropriate remedies, will take into account our assessment of the effects of these recent actions; the responses to our provisional findings; and responses to this provisional decision on remedies.

The adverse effect on competition

1.12 In our provisional findings;⁷ we found that the following features of the market prevented, restricted or distorted competition:

(a) Barriers to switching:

- (i) companies face significant hurdles in comparing the offerings of the incumbent firm and alternative suppliers outside of a tender process;
- (ii) it is difficult for companies to judge audit quality in advance due to the nature of audit.
- (iii) Companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced efficiency in the conduct of the audit and increased risk in the technical quality of the audit.

(b) Company management face significant opportunity costs due to the management time involved in the selection and education of a new auditor.

(c) Mid Tier firms face experience and reputational barriers to selection in the FTSE 350 audit market.

⁷ Provisional findings, Section 13, paragraphs 3 & 7.

- (d) Misaligned incentives between auditors, shareholders, and company management so that audit firms compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ.
- (e) Auditors face barriers in the provision of information that shareholders demand (in particular from the reluctance of company management to permit further disclosure).

1.13 We provisionally found that the features listed in (a) to (b) above give rise to an AEC either individually or in combination by weakening a company's bargaining power with regard to its incumbent auditor outside a tender process. We think that these features are pervasive throughout the FTSE 350 statutory audit market but their impact will be uneven across companies. How a feature or combination of features impacts on an individual company's strength of bargaining power will vary over time and depend on its particular circumstances.⁸

1.14 We provisionally found that the feature listed in (c) above either individually or in combination with other features gives rise to an AEC as companies have a more restricted choice of auditor than would otherwise be the case.⁹ We provisionally found that the features listed in (d) and (e) result in auditors being less independent and less responsive to shareholder demand than they would be in the absence of such features.¹⁰

Detrimental effects on customers

1.15 We considered the nature and extent of detrimental effects on customers resulting from the AEC, as set out in our description of the legal framework in paragraph 1.5

⁸ Provisional findings, paragraph 13.4.

⁹ Provisional findings, paragraph 13.5.

¹⁰ Provisional findings, paragraph 13.8.

above. A detrimental effect on customers includes such an effect on future customers.¹¹

1.16 The Act requires us to consider the effects on customers other than those in the market directly affected by the features we found. We consider those directly affected customers in this context to be FTSE 350 companies and their shareholders, both current and future. We also considered the extent to which customers in other markets (and so the UK economy at large) may be adversely affected given the public good aspect of audit and its potential, as part of the overall UK corporate governance framework, to influence inwards investment and growth and productivity of UK firms.

1.17 In our provisional findings we said that as a result of the AEC, companies are offered higher prices, lower quality, and less innovation and differentiation¹² than would otherwise be the case.¹³ We said that, in a typical market, if prices are above competitive levels, then fewer customers buy the relevant product, which produces a 'total welfare loss'. In this market, the demand for statutory audit is inelastic since every FTSE 350 company must buy an audit. If audit fees are excessive then this may be regarded as a transfer of wealth between companies and audit firms, and shareholders may suffer detriment as a result.

1.18 We consider that wider welfare losses are likely to arise if the AECs we provisionally identified decrease audit quality. These wider welfare losses extend beyond shareholders in individual companies to customers in other markets and so have implications for the economy as a whole. We discuss these wider welfare losses first

¹¹ [Section 134\(5\)](#).

¹² We regard differentiation as an aspect of choice.

¹³ Provisional findings, paragraph 13.6.

before returning to the subject of wealth transfer between companies (and by corollary their shareholders), and audit firms in paragraph 1.34.

1.19 In our provisional findings we described the broader benefits in terms of the contribution of audit to effective corporate governance and the efficient operation of financial markets, including debt and equity markets. We said that the economic benefits of audit go beyond the private benefits to shareholders and management of a company.¹⁴ The role of high-quality audit as a pillar of good corporate governance is uncontroversial. The wider economic benefits of investors being able to make better informed decisions and exercise control more effectively include more efficient capital markets, better allocation of capital and high growth and productivity.

1.20 The G8 said:¹⁵

Efficient capital markets are critical to achieving and maintaining economic growth. To support growth, economies need sound legal systems, effective regulation and transparent corporate governance practices. These factors underpin effective disclosure that is fundamental to well-functioning markets. Sound social frameworks and attention to the long-term impacts, including on the environment, of investment decisions and business processes are also important for sustainable growth

Timely and accurate information assists shareholders in exercising control and investors in allocating funds to their most productive uses.

In support, governmental authorities should ensure that corporate reporting assists them in monitoring markets and in identifying vulnerabilities.

¹⁴ Provisional findings, paragraphs 5.27 & 5.28.

¹⁵ The G8, Fostering growth and promoting a responsible market economy: A G8 Declaration, Evian, 2 June 2003.

Trust and confidence are key ingredients of a well-functioning market economy. Restoring investor confidence through sound corporate governance, as well as corporate structures and market intermediaries that are more accountable, is essential to promoting growth in our economies. We encourage the many initiatives underway, in national capitals, international financial institutions and by international standard-setting bodies, to strengthen governance standards and disclosure regimes.

Corporate integrity, strengthened market discipline, increased transparency through improved disclosure, effective regulation and corporate social responsibility are common principles that are the foundations for sound macro-economic growth.

1.21 The OECD said:

Good corporate governance provides incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and facilitates effective monitoring. More effective monitoring increases investor confidence in the future performance of those companies, and lowers the cost of capital. It encourages firms to use and allocate resources more efficiently, thereby underpinning growth.¹⁶

1.22 In summary we consider that the implications of a shortfall in audit quality arising from the AEC that we provisionally found are:

- (a) that individual shareholders have less reliable financial information on which to ensure effective oversight of corporate decisions, including capital allocation decisions. Company performance and shareholder returns are lower as a result.

¹⁶ Based on OECD Principles of Corporate Governance 2004.

The aggregate consequences of this are ultimately lower productivity and growth in the UK economy; and

(b) we expect there to be a wider detriment to the economy due to an undermining of trust in the quality of financial reporting, and hence a higher cost of capital than would otherwise be the case.

1.23 Audit is often referred to by audit firms as synonymous with ‘assurance’ (ie giving assurance to shareholders that company financial statements are materially accurate).¹⁷ As well as underpinning market confidence in individual companies’ financial reporting, audit also plays a role in the trustworthiness of financial reporting more generally and confidence in the UK as a place to invest.

1.24 There is a well-established literature showing that high corporate governance standards can enhance firms’ valuation. The following examples were cited by the FSA:¹⁸ La Porta et al (2002) find a positive correlation between investor protection and company performance across countries. Deutsche Bank (2005) finds a positive correlation between the corporate governance standard of a firm and its share price performance. Those companies with the highest corporate governance standards outperformed those with the lowest standards by 34 per cent. Bruno and Claessens (2007) find a positive correlation between the level of corporate governance and firm performance. Likewise, there is a well-established literature on the link between good corporate governance and cost of capital. The following examples were cited by KPMG:¹⁹ 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. Lambert, Leuz and Verrecchia (2007) found that

¹⁷ ISA 200—The overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK & I), paragraph 3, states ‘The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.’

¹⁸ See FSA Empirical Research on the UK Listing rules and Firm Valuation, ‘A review of the Structure of the Listing Regime’, FSA 08/01, Annex 2, January 2008.

¹⁹ [KPMG response to the Remedies Notice](#), paragraphs 4.2.6.1 & 4.2.6.2.

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

1.25 To the extent that FTSE 350 companies are self-financing²⁰ the availability and cost of debt and equity in the external capital markets may have a limited direct effect on financing costs. However, the external capital markets dictate the opportunity cost of capital for these firms and hence have a direct impact on firm valuation. In addition, equity markets play an important role in providing oversight of companies' internal capital allocation decisions. Auditors underpin the provision of high-quality information that investors need to undertake this monitoring role and thus support effective corporate governance in these companies.

1.26 The 'trust' aspect of audit is fundamental given that it is a credence good for shareholders. While greater visibility of audit quality may be achievable there will always be significant information asymmetry between shareholders and audit firms, given shareholders' lack of access to sensitive financial information and to the detail of the audit process.²¹ An important implication of this is that, since they cannot judge quality directly, investors form perceptions of audit quality from a variety of sources and these perceptions may at times depart from reality.²² Nevertheless, if investors do not trust the audit product in some respects, its power to instil confidence will be diminished.

1.27 Doubts among investors regarding the quality of a small number of audits could seriously undermine their trust in the information provided by statutory audits.²³ Because of the importance of perception, we think that even relatively infrequent or

²⁰ See The Kay Report for a discussion of this issue.

²¹ Provisional findings, paragraph 5.56.

²² See Oxera's Investor Survey: Investors expressed divergent views on whether the audit market was delivering well. One investor said it did not have sufficient information to judge the issue.

²³ Provisional findings, paragraph 5.59.

isolated reported instances of significant quality issues could have a large detrimental effect, because they undermine trust in the integrity of audit. Instances where auditors have been found to lack scepticism are likely to be damaging in this respect.

- 1.28 Given the above, we consider that our finding that there are features that result in auditors being less independent and less responsive to shareholder demand than they would otherwise be has important implications for our assessment of detriment.
- 1.29 We noted, in particular, the concerns of the FRC in regard to professional scepticism, expressed in AQR team reports over recent years. The 2012/13 AQR team Annual Report notes an overall improvement in the area of scepticism based on the sample of reviews and other work conducted during the year but continues to raise a number of concerns notably in respect of impairment testing of goodwill and other intangibles; and loan loss provisioning in financial service audits.²⁴ Relevant comments from the FRC's report²⁵ include:
- (a) While these inspection reports are encouraging, further improvement is still required in a number of key areas. Many of these areas are recurring in nature including the exercise of sufficient professional scepticism and the approach to independence and ethics.
 - (b) Initiatives to reinforce the importance of professional scepticism appear to be working although progress is not uniform.
 - (c) Firms should ensure that further improvements and greater consistency are achieved.

²⁴ [Audit Quality Inspections Annual Report 2012/13: 'Key messages'](#).

²⁵ *ibid.*

(d) We continue to raise a number of concerns notably in respect of the auditor's review of the assumptions used for the impairment testing of goodwill and other intangibles.

(e) In relation to Financial Services, further improvements are required. Firms should strengthen their testing, particularly in respect of loan loss provisioning and general IT controls.

1.30 Audit firms disputed that there was any lack of professional scepticism, and disagreed with our provisional view that there were significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies. Deloitte said that our conclusion was no more than that 'losses of auditor independence do occur' and gave no indication of the scale of the problem.²⁶ KPMG said that we tended to overstate the negative findings of the AQR team²⁷ and said that individual lapses should be seen in the context of high overall audit quality.²⁸

1.31 We continue to assess the evidence, including the responses to the provisional findings, on the subject of quality and professional scepticism. Our current view is that there is evidence of shortfalls in quality based on the findings of the AQR team, and that while there is some evidence of improvement over time, professional scepticism continues to be a concern. The relative frequency of these shortfalls is difficult to determine precisely, given that the AQR team's sampling methodology is not designed to be representative of the FTSE 350 as a whole, but, for the reasons discussed in paragraph 1.27 even relatively infrequent notable instances are likely to have a significant detrimental effect on confidence. This is particularly the case given that the AQR team inspects a sample of audits biased towards more complex listed entities in which the importance of high quality audit may be regarded as paramount.

²⁶ [Deloitte response to the provisional findings](#), paragraph 5.11(e).

²⁷ [KPMG response to the provisional findings](#), paragraph 2.6.3.2.

²⁸ [KPMG response to the provisional findings](#), paragraph 2.6.3.4.

- 1.32 We place significant weight on the views of investors in this regard. In our provisional findings we noted comments from investors suggesting that concerns regarding professional scepticism continued to be an issue.²⁹ A coalition of investors said that audit quality (and ultimately trust in capital markets) depended on real and perceived auditor independence. Auditor independence provided a basis for ensuring professional scepticism and prudence in analysis and willingness to challenge management vigorously. Currently it was very difficult for shareholders to ascertain whether auditors were independent of the executive.³⁰
- 1.33 We consider that the competition problems that we have found contribute to a lack of confidence in the auditing profession. In a recent article,³¹ Mr Nick Land, non-executive director of the FRC and ACC of Vodafone, said ‘Fair or unfair, the perception of the auditing profession in the UK and many parts of the world is very low. I think there is a lack of confidence and trust in the role of auditors.’ This lack of confidence is not unanimous: BDO LLP’s (BDO’s) investor survey noted that a significant number of investors are content or broadly content with the way the market is delivering. On the other hand, around half of the investors surveyed expressed serious concerns.³² USS said that ‘Circumstantial evidence and audit quality inspections reveal grave concerns with audit quality’.³³
- 1.34 Turning to the ‘private’ costs that we would expect to result from the AEC that we have provisionally found, we consider that companies on average tolerate higher prices and lower quality because they regard the costs of going out to tender and switching auditor to be significant. This means that companies are likely to tolerate

²⁹ Provisional findings, paragraph 7.142.

³⁰ USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (representing 56 pension funds), Governance for Owners, Environment Agency Active Pension Fund and Sarasin and Partners LLP, 10 April 2013.

³¹ *Economia*, 11 February 2013: economia.icaew.com/opinion/february2013/tales-from-the-front-line.

³² See Oxera: Investor views on market outcomes and on potential remedies in the provision of audit services, August 2012, Figure 2.1.

³³ [USS submission to the CC](#), May 2012.

higher prices or lower quality to the extent that any expected benefit to be obtained is not greater than the perceived cost of going out to tender and switching audit firm.

This may be expected to have a detrimental effect on shareholder value, on average across FTSE 350 companies.

1.35 This is supported by evidence that switching auditor is typically associated with a fee reduction.³⁴ We are continuing to assess the evidence in this area.

1.36 This is also supported by case study evidence. We heard examples of companies who had experienced quality issues but had not immediately gone out to tender. For example, the audit firm had ceased to deliver a 'value-added' service to company management and was not providing the expected insights and advice that could improve the performance of the company (eg on the control environment). Some companies had given their audit firm a chance to improve before going to tender, including by replacing the Audit Engagement Partner (AEP),³⁵ or had tolerated shortfalls in quality because other priorities had meant that it had not been a convenient time to go out to tender. Examples from our case studies on this point are described in Appendix 1.1.

1.37 We now turn to the extent to which market outcomes (including prices and quality) differ from those we would expect in a well-functioning market. If competition were directed more fully towards the demands of the shareholder, we consider that the audit product, and the competitive process itself, would be different in certain respects. We consider that the quality demanded is likely to be different: shareholders are likely to place greater emphasis on professional scepticism and thoroughness, and ensuring sufficiency of work performed. A further implication of a

³⁴ Provisional findings, paragraph 7.39.

³⁵ Provisional findings, paragraph 9.199, cites three instances where companies had the actual or proposed lead partner changed where they were dissatisfied with performance.

reduction in the influence of the Finance Director (FD) in the external audit relationship is that firms' competitive activity is likely to be different in nature. Firms currently invest significant time developing and maintaining relationships with executives at non-audit clients, in order to position themselves favourably in the event of a tender process (and also to attempt to encourage a tender process).³⁶ We consider that such activity will be less if the influence of the executive over the decision to go out to tender and appoint auditors were lower and competition is more focused on more frequent, well-structured tender processes.

- 1.38 There are considerable difficulties involved in specifying precisely the dimensions of the competitive product in this market and it may differ in significant respects between companies and over time. If competition functions effectively and towards the right demand, it will be for the market to specify the quality and price of the competitive product (subject to compliance with regulatory standards). We consider that this will best be discovered over time through the process of competition, with appropriate remedies in place to ensure that competition is effective and accurately focused on the demands of shareholders.
- 1.39 Given the importance of high-quality FTSE 350 audits to shareholders and the UK economy we consider that the detriments that we have identified in paragraphs 1.22 to 1.36 are likely to be significant. The importance of trust in this market means that even small imperfections or relatively isolated instances of shortfalls in quality applying to some companies but not all, or only at certain times, may be damaging as they undermine credibility and confidence in the quality of the corporate governance framework. Shareholders are not in a position to assess accurately the extent to which reports of shortfalls in audit quality are isolated or indicative of more pervasive problems, as shareholders have little ability to identify where low audit quality has

³⁶ Provisional findings, paragraphs 9.37–9.45.

been found and we consider that such instances may therefore be expected to undermine trust in the integrity of the audit product more generally.

- 1.40 We note that the corporate governance framework in the UK scores well in international comparisons, although BIS notes that some rankings have fallen since the credit crunch. We accept that audit quality is only one part of the overall corporate governance framework.
- 1.41 Even very small effects that improve the value of firms as a result of an improvement in audit quality could have very large financial benefits. The public benefit of increased trust in audit could extend significantly beyond the FTSE 350. We recognize that there are difficulties in quantifying the detriment as a result of the AEC that we have provisionally found, however, we consider that it is likely to be significant. As at the end of February 2013, the market capitalization of the FTSE 350 stood at £1,876.5 billion. Every basis point (0.01 per cent) increase in the market capitalization of the FTSE 350 would represent a benefit to shareholders of around £200 million. On an illustrative basis, every basis point decrease in the cost of capital could represent an increase in overall market capitalization of around £3.8 billion.³⁷ We cannot be precise as to the quantum of any increase in company value arising from an improvement in the corporate governance framework, however, the above illustrates that even small effects could have large financial benefits.
- 1.42 We will take these detrimental effects into account in evaluating the proportionality of our remedy package (Section 5).

Structure of our provisional decision

- 1.43 The remainder of this provisional decision is structured as follows. We:

³⁷ Based on an initial discount rate of 5 per cent and assuming constant cash flows in perpetuity.

- (a) by way of background, set out relevant aspects of the regulatory landscape and recent developments (Section 2);
- (b) discuss in turn each of the remedy options that we have provisionally decided should form part of our remedy package (Section 3);
- (c) discuss the other remedy options that we have considered, which do not form part of our proposed remedy package (Section 4);
- (d) consider whether there are relevant customer benefits (RCBs) arising from the features giving rise to the AEC which would be lost if we imposed our proposed remedy package and if so whether we should seek to ensure that we retain any such benefits by modifying our remedy package (Section 5, paragraphs 5.39 to 5.48); and
- (e) assess the overall effectiveness and proportionality of the proposed remedy package (Section 5, paragraphs 5.49 to 5.93).

2. The regulatory landscape and recent developments

- 2.1 By way of background, we set out key provisions of the UK Corporate Governance Code and the Stewardship Code, as these are key facets of the UK corporate governance framework. We also set out recent changes to the UK Corporate Governance Code which have important implications for our remedy package and consider relevant recent changes to auditing standards. These changes, as well as changes being consulted on, are discussed in more detail in Section 3 where relevant to individual remedy options. Finally we summarize recent developments at a European Union level concerning the audit market.

The UK Corporate Governance Code

- 2.2 The FRC publishes the UK Corporate Governance Code which sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. The UK Corporate Governance Code

states that boards should establish an AC comprised of non-executive directors, and sets out minimum requirements for the roles and responsibilities of the AC.³⁸

- 2.3 Since 2010, the UK Corporate Governance Code has stated that a separate section of the annual report should describe the work of the AC in discharging its responsibilities³⁹ (the Audit Committee Report).
- 2.4 Companies with a Premium listing⁴⁰ of equity shares in the UK are required under the Listing Rules either to comply with the provisions of the UK Corporate Governance Code or to explain to shareholders why they have not done so. Guidance on what constitutes an explanation under 'comply or explain' was issued in February 2012.⁴¹
- 2.5 Compliance with the UK Corporate Governance Code varies and there is some evidence that not all FTSE 350 companies give adequate explanations for non-compliance. In its 2012 review of Corporate Governance in the FTSE 350, Grant Thornton UK LLP (GT) analysed the annual reports of 296 companies in the FTSE 350 and found that 51 per cent of FTSE 350 companies comply with the entirety of the provisions of the UK Corporate Governance Code, and that this was consistent with 2010 and 2011. A further 35 per cent of companies do not comply with all the provisions of the Code, but explain any non-compliance with an appropriate explanation, and another 14 per cent of companies do not comply with one or more provisions but do not make a full explanation. Overall GT calculated that 97 per cent of all provisions were complied with.⁴²

³⁸ A description of the relevant aspects of the June 2010 version of the Code is in the provisional findings, Appendix 8.

³⁹ 2010 CGC – C3.3.

⁴⁰ Issuers with a 'premium listing' are required to meet standards, as specified in the Listing Rules, higher than EU minimum requirements.

⁴¹ www.frc.org.uk/getattachment/590dd61a-d3b1-4a2e-a214-90f17453fa24/What-constitutes-an-explanation-under-comply-or-explain.aspx.

⁴² Grant Thornton, Corporate Governance Review, 2012, p8.

2.6 One provision of relevance which is sometimes not followed is establishing an AC with three or more independent non-executive directors, with one member having recent or relevant experience.⁴³

2.7 We discuss the implications of 'comply or explain' on individual aspects of our remedy package in further detail in Section 3.

2.8 In September 2012 the UK Corporate Governance Code was changed in certain respects. Two changes are particularly relevant to our consideration of remedies:

(a) Expanded guidance on the matters that should be covered in the Audit Committee Report:

The report should include: the significant issues it considered in relation to the financial statements, and how these issues were addressed; an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment and reappointment of the external auditor, including the length of tenure of the current audit firm and when a tender process was last conducted; and, if the external auditor provides non-audit services an explanation of how auditor objectivity and independence is safeguarded.⁴⁴

(b) FTSE 350 companies should put the external audit contract out to tender at least every ten years.⁴⁵

2.9 In addition, the revised UK Corporate Governance Code contains a provision that:

'Where requested by the board, the audit committee should provide advice on

⁴³ Grant Thornton, Corporate Governance Review, 2012, p41. Of 144 FTSE 350 companies not fully complying with the Code, 22.8 per cent, (about 32 companies) did not comply with clause C.3.1 of the Code.

⁴⁴ FRC, [The UK Corporate Governance Code](#) (September 2012), C3.8. This paragraph replaces Provision C3.7 which read as follows: 'The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.'

⁴⁵ FRC, [The UK Corporate Governance Code](#) (September 2012), C3.7.

whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.⁴⁶

2.10 The changes apply to reporting periods beginning on or after 1 October 2012. Since many FTSE 350 companies have December year ends, the first reporting annual reports prepared under the revised Code will be published around late March 2014. We consider the effects of these changes to the UK Corporate Governance Code and the extent to which they may be expected to address the AEC that we provisionally found in Section 3.⁴⁷

2.11 In addition to the UK Corporate Governance Code, the FRC publishes a series of guidance notes intended to assist companies address specific aspects of the Code. The FRC's Guidance on Audit Committees (Guidance on ACs) is particularly relevant to our consideration of remedies.⁴⁸ The Guidance on ACs is designed to assist company boards in making suitable arrangements for their ACs, and to assist directors serving on ACs in carrying out their role. While boards are not required to follow this guidance, it is intended to assist them when implementing the relevant provisions of the UK Corporate Governance Code.

2.12 In September 2012, the Guidance on ACs was expanded to reflect the changes made to the UK Corporate Governance Code. Further detail about these changes and the likely effect is discussed in further detail in Section 3.⁴⁹

⁴⁶ 2012 CGC 3.3.

⁴⁷ Changes in relation to AC reporting are discussed under the AC and auditor reporting remedy; changes in relation to tendering after ten years are discussed under the audit tendering remedy.

⁴⁸ www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-September-2012.aspx.

⁴⁹ See Extended Reporting requirements.

The Stewardship Code

- 2.13 The UK Stewardship Code aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. The Stewardship Code sets out good practice on engagement with investee companies and operates on a 'comply or explain' basis. The FCA requires UK-authorized asset managers to report on whether or not they apply the Stewardship Code.
- 2.14 The Stewardship Code is based on the 'Code on the Responsibilities of Institutional Shareholders', published in 2009 by the Institutional Shareholders Committee. The Walker Report on the governance of banks and other financial institutions recommended that the FRC should take responsibility for the Code and the FRC adopted the code, with some limited amendments, as the Stewardship Code, in July 2010. As at December 2011, the Stewardship Code had 234 signatories. It was revised, following consultation, in April 2012.⁵⁰
- 2.15 The Stewardship Code is not intended to be a rigid set of rules. Rather, it consists of a set of seven principles and guidelines on how those principles may be implemented. Its principal aim is to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. Regarding the scope of the Stewardship Code, the FRC has said :
- The Code is directed in the first instance to institutional investors, by which is meant asset owners and asset managers with equity holdings in UK listed companies. Institutional investors may choose to outsource to external service providers some of the activities associated with stewardship. However, they cannot delegate their responsibility for

⁵⁰ All seven principles of the Stewardship Code, however, remained unchanged.

stewardship. They remain responsible for ensuring those activities are carried out in a manner consistent with their own approach to stewardship. Accordingly, the Code also applies, by extension, to service providers, such as proxy advisors and investment consultants.⁵¹

- 2.16 The FRC sees the Stewardship Code as complementary to its UK Corporate Governance Code (and as noted above, both are applied on a 'comply or explain' basis).
- 2.17 Signatories are encouraged to review their policy statements annually, and update them where necessary to reflect changes in actual practice. This should be on the signatory's website, or if they do not have a website, in another accessible form. There should also be an indication of when the statement was last reviewed.
- 2.18 The FRC monitors the take-up and application of the Stewardship Code. It expects the contents of the Code to evolve over time to reflect developments in good stewardship practice, the structure and operation of the market, and the broader regulatory framework. Unless circumstances change, the FRC does not envisage further changes to the Stewardship Code until 2014.
- 2.19 The seven principles of the Stewardship Code are as follows:
- (a) So as to protect and enhance the value that accrues to the ultimate beneficiary, institutional investors should:
- (i) publicly disclose their policy on how they will discharge their stewardship responsibilities;
 - (ii) have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed;

⁵¹ FRC, The UK Stewardship Code, p2.

- (iii) monitor their investee companies;
- (iv) establish clear guidelines on when and how they will escalate their stewardship activities;
- (v) be willing to act collectively with other investors where appropriate;
- (vi) have a clear policy on voting and disclosure of voting activity; and
- (vii) report periodically on their stewardship and voting activities.

2.20 The seven principles are backed up by guidance as to how to achieve those principles.

Changes to auditing standards

2.21 In February 2013, the FRC issued a consultation paper proposing changes to ISA (UK & Ireland) 700—The independent auditor’s report on financial statements. The consultation asked for responses to the FRC’s proposal to increase the level of disclosure made by auditors on the planning and execution of the audit of the audited entity. On 4 June 2013, the FRC issued a revised ISA 700 which incorporated these proposals. The revised standard will be effective for audits of entities which adopt the UK Corporate Governance Code for reporting periods beginning on 1 October 2012. We consider the effects of these developments in further detail in Section 3 (see paragraphs 3.430 to 3.464).

2.22 The International Auditing and Assurance Standards Board (IAASB) is also consulting on revising or introducing new ISAs on auditor reporting with exposure drafts scheduled for publication in June 2013 and final approval of a revised standard is expected in June 2014.

European Union developments

- 2.23 European Union proposals on the functioning of the audit market are currently in draft form. Our understanding of the current status of the negotiations with member states is as follows, however, discussions are ongoing, so these are subject to change. There has been agreement on the scope of the draft Regulation, namely that it should apply to Public Interest Entities (PIEs)—ie listed companies and financial institutions. There is likely to be a provision to the effect that member states can add additional entities to the category of PIEs.
- 2.24 On the issue of mandatory rotation, there is currently support for the principle both in the European Parliament and in the Council. Discussions are still ongoing on the scope and duration of the principle of rotation.
- 2.25 On the issue of prohibition of NAS, the proposals are almost finalised. There is likely to be a ‘black list’, with all other services permissible. There are further discussions on a cap on audited-related services.
- 2.26 EU proposals in relation to the prohibition of Big-4-only clauses had universal acceptance.
- 2.27 The next step was to get a political mandate to enter into trilogue negotiations with the Parliament and the European Commission. The objective of the Presidency is to obtain a negotiation mandate by September, and to reach political agreement before the end of 2013.

3. Remedy options that we are proposing to take forward

- 3.1 In this section we discuss the remedy options that we propose to take forward as our preferred remedy package. We propose remedies in relation to the following areas:

- Remedy 1: Tendering of audit services—paragraphs 3.3 to 3.176.
- Remedy 2: AQR—paragraphs 3.177 to 3.257.
- Remedy 3: Auditor clauses in loan documentation—paragraphs 3.258 to 3.312.
- Remedy 4: Enhanced shareholder engagement—paragraphs 3.313 to 3.370.
- Remedy 5: Strengthened accountability of the external auditor to the AC—paragraphs 3.371 to 3.426.
- Remedy 6: Extended AC reporting—paragraphs 3.427 to 3.478.
- Remedy 7: Competition duty on the FRC—paragraphs 3.479 to 3.526.

3.2 For each of these remedy options we discuss the aims and objectives of the remedy option; consider specific design issues; and evaluate effectiveness and costs. We also consider implementation and enforcement issues on a remedy-specific basis.

Assessment of Remedy 1: Mandatory tendering

Summary

We provisionally intend to issue an Order to the effect that:

- FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. Companies may defer this obligation for up to two years in exceptional circumstances. The reasons must on each occasion be set out in the Audit Committee Report. Companies must go out to tender by the end of year 7. This compares with the current FRC provisions that require companies to go out to tender every ten years on a ‘comply or explain’ basis with no limit specified on the number of years that a company could opt to ‘explain’.
- Companies have the right to require the incumbent audit firm give them access to specified elements of the audit file for disclosure to rival bidders in a tender process.

Companies must monitor and certify compliance with the provisions of the Order in the Audit Committee Report.

We also provisionally intend to recommend that the FRC amend the UK Corporate Governance Code in line with the provisions of the proposed Order.

Introduction

- 3.3 The FRC's recently revised UK Corporate Governance Code requires companies to go out to tender every ten years on a 'comply or explain' basis. In the Remedies Notice we suggested FTSE 350 companies may need to tender the audit more frequently than that to address the AEC that we provisionally found.
- 3.4 We asked for comments in relation to two options, namely that FTSE 350 companies should go out to tender their external audit at least every five or seven years. We proposed that the increased frequency of seeking tenders should be mandatory and did not favour a 'comply or explain' provision as this could undermine compliance (if companies were able to explain repeatedly and even indefinitely). We envisaged going out to tender significantly before the end of the set period would be relatively unusual.
- 3.5 In the light of responses received to the Remedies Notice, we considered further options, namely:
- (a) a requirement to go out to tender every ten years with the ability to 'explain' for a maximum of two years. We consider that such a remedy would have the effect of reinforcing the FRC's provisions in the UK Corporate Governance Code; and
 - (b) a requirement to go out to tender every seven or five years with the opportunity for the company to delay the tender process for a maximum of two years on a 'comply or explain' basis. We consider that this option would provide the flexibility companies may need to avoid being required to go out to tender at a time that would not be in their shareholders' best interests.
- 3.6 We also proposed that the tendering process should be conducted on an 'open-book' basis in which tendering firms would have access to relevant information from the company and the files of the incumbent auditor to enable the firms to have an

accurate understanding of the company's control environment and all significant audit issues. We have considered a modification to this remedy that would give the AC the power to require the incumbent to give them access to specified parts of the audit file for disclosure to rival bidders.

3.7 It is our provisional view that:

- (a) FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. Companies may defer this obligation for up to two years in exceptional circumstances. The reasons must on each occasion be set out in the Audit Committee Report. Companies must go out to tender by the end of year 7. This compares with the current FRC provisions that require companies to go out to tender every ten years on a 'comply or explain' basis with no limit specified on the number of years that a company could opt to 'explain';⁵² and
- (b) Companies should have the right to require the incumbent audit firm to give them access to specified elements of the audit file to rival bidders in a tender process.

3.8 In this section we consider the aim, context and effectiveness of this remedy and explain why we have provisionally decided that five years (with the option to delay for a maximum of two years) is the appropriate interval. The structure of the section is as follows:

- (a) Aim of the remedy.
- (b) Relevant background.
- (c) Summary views of parties.
- (d) Assessment of the effectiveness of the proposed remedy (as described in paragraph 3.7).
- (e) Our view of the appropriate frequency of mandatory tendering.

⁵² In the remainder of this section we refer to this as a requirement to tender every five years. We do not mention each time the possibility for companies to delay a tender for a maximum of two years.

(f) Enforcement and implementation (including phasing in).

Aim of the remedy

- 3.9 We proposed a remedy of mandatory tendering because we provisionally found that there were features of the market which created barriers to companies effectively testing the market in the supply of audit services to ensure that they were receiving a competitive service. We found that companies appeared reluctant to go out to tender unless seriously contemplating switching auditors.
- 3.10 We consider that regular tender processes would be desirable as the appointment of the auditor will be more informed, transparent and accountable than is currently the case in many companies. In particular:
- (a) tenders appear to date to have been structured processes which provide firms with the information they need to submit informed proposals and consequently companies are provided with better information on which to base decisions on the auditor appointment; and
 - (b) tenders are transparent processes in which the AC has a significant role in consultation with other board members on the selection of the auditor. We consider that the transparency of the process and the influence of the AC will be reinforced by the recent FRC reporting requirements imposed on ACs under the UK CGC. Implementation of Remedy 1 (mandatory tendering) in combination with other measures in our remedy package designed to increase the influence of the AC and encourage greater shareholder engagement would build on this.
- 3.11 We were also told by companies in recent case studies (see paragraph 3.23) that tender processes provided companies and firms with an opportunity to review and update the audit process and relationship.

- 3.12 In paragraphs 3.13 to 3.17 below we expand on how more frequent tender processes would contribute to addressing the AEC. We set out how we think this remedy:
- (a) increases companies' bargaining power; (b) addresses barriers to entry; and
 - (c) better aligns auditor and shareholder interests.

How the remedy increases companies' bargaining power

- 3.13 We consider that the remedy would increase the bargaining power of FTSE 350 companies in the following ways:
- (a) It would increase the frequency of open competitions for FTSE 350 audit engagements. We provisionally found that when companies go out to tender they fully exercise their bargaining power.
 - (b) It would increase the bargaining power of companies in the annual reappointment of the incumbent auditor. We have said that in the early years of an engagement companies will be better informed on their outside options and so in a better position to assess the performance of the incumbent auditor. We also consider that the effect will be to strengthen the incentives of an audit firm to offer a competitive product (particularly as the threat of a tender process gets closer) as it will be aware that any failure to do so will become apparent to the client in the upcoming tender process at the latest.
 - (c) The information gained from going out to tender every five to seven years on the offers of rival audit firms will be shared across FTSE 350 companies as a consequence of most ACCs (and other non-executives who may be involved in the tender process) holding more than one FTSE 350 position. Also, as a result of information being shared on the benefits of going to tender and how to conduct tender processes efficiently, companies will be able to streamline their processes and tender requirements.

How the remedy addresses barriers to entry

- 3.14 More frequent opportunity to compete for engagements, and more certainty over the timing of these opportunities, may provide firms with greater incentives to invest in expanding their capabilities. We consider this to be relevant both to Big 4 firms with weaker positions in some sectors and to non-Big-4 firms that currently have very few FTSE 350 engagements. The strength of this effect will depend on the firms' assessment of the likelihood of success in winning engagements when they become available. Accordingly, we consider that over time mandatory tendering may also strengthen the bargaining position of companies by increasing the number of alternative providers of audit services.

How the remedy better aligns auditor and shareholder interests

- 3.15 We consider that mandatory tendering could have the effect of reducing the incentives of auditors to compete to satisfy management, rather than shareholder, demand. In particular:
- (a) Mandating tendering significantly reduces the influence of executive management on the decision of whether or not to go out to tender. Our evidence suggests that CFOs/FDs are influential in the decision to go out to tender (see our first survey results). In taking this decision they might take insufficient account of the benefits to shareholders where their interests do not align with those of shareholders.
 - (b) Having decided to go out to tender, whilst FDs typically take the lead in the management of a tender process, ACCs are influential in the assessment of the rival bids and the decision on the auditor to be appointed. As the representative of the interests of the shareholders, we expect ACCs to regard scepticism and technical quality as important factors in the selection of an auditor.⁵³

⁵³ The CC's first survey found that 97 per cent of ACCs said that high degree of auditor challenge was important in the assessment of audit quality. See provisional findings, Appendix 3, Table 10.

(c) Tenders have been detailed and transparent processes (see the provisional findings, paragraph 9.255) which have provided senior management and the AC with the opportunity to reflect on and scrutinize their relationships with the auditor.

3.16 The case studies (see Appendix 1.1) indicate that historically whilst the tender process would typically be managed by the FD and his team,⁵⁴ the role of the ACC would be to ensure that the process was thorough and fair. The ACC would therefore be involved in the design of the process and the establishment of the evaluation criteria, as well as in interviewing and selection. The selection decision would typically be made by a panel, using a balanced scorecard approach to assess the extent to which participating firms met the evaluation criteria.

3.17 The FRC said that regular tendering of the external audit contract reduced the perception of a familiarity threat by ensuring that the relationship was subject to open market competitive review on a periodic basis; it provided an opportunity for new personnel and audit techniques to be deployed and so might lead to improvements in audit quality and innovation; and it allowed ACs to make their own judgements about the balance of risk between familiarity and inexperience.⁵⁵

3.18 We consider that a requirement to go out to tender more regularly would change the nature of competition for audit engagements. We have observed that competition for engagements has involved audit firms devoting considerable resources, in particular partner time, to identifying potential clients and building relationships with the aim of encouraging companies to seek tenders for audit engagements or ensuring that the firm would be well placed to bid were the opportunity to arise (see paragraph 3.84). It appears to us that these efforts are more frequently targeted at FDs (see the

⁵⁴ We encountered no female FDs in our case study exercises.

⁵⁵ See the FRC's Feedback Statement of September 2012—www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Feedback-statement-on-UK-Corporate-Governance-Code.aspx.

provisional findings, Appendix 3 ('CC's first survey results'), paragraph 77). We consider that if engagements are regularly put out to tender, the main focus of competition would shift towards such tender processes, in which the AC is influential.

3.19 We consider that the effectiveness of a remedy that promotes more frequent use of tender processes would be greater if implemented in combination with other remedies aimed at promoting the role of the AC, as representatives of the interests of shareholders, and shareholders themselves in the oversight of the audit engagement. In particular, we consider that Remedies 5 (strengthened accountability of auditor to AC) and 6 (extended AC reporting) would contribute to ensuring that competition in tender processes takes place on the variables that matter to shareholders.

Relevant background

3.20 In paragraphs 2.8 to 2.15 we set out the changes the FRC made in September 2012 to the UK Corporate Governance Code and Guidance on ACs. We consider the following to be most relevant to the assessment of Remedy 1:

- (a) FRC amendments to the UK Corporate Governance Code that require companies to go out to tender the external audit engagement at least every ten years on a 'comply or explain' basis;
- (b) FRC guidance on what would constitute an explanation under a comply or explain provision; and
- (c) FRC Guidance on ACs on Audit Tenders.⁵⁶

3.21 How the requirement for companies to go out to tender at least every ten years on a 'comply or explain' basis will operate in practice is somewhat uncertain and, as it is in its early stages, the effect on both company and firm behaviour is unclear. In

⁵⁶ [Audit Tenders: Notes on Best Practice, FRC July 2013.](#)

particular, it is uncertain what would constitute a satisfactory explanation and therefore for how many years a company could reappoint the incumbent auditor without a tender process. We consider the evidence on this point below.

- 3.22 We also consider the requirement under current Ethical Standards issued by the Auditing Practices Board that the AEP must normally change after five years to be relevant to the assessment of the appropriate period between tender processes.

Views of parties

- 3.23 We summarize briefly below the views of (a) the investor community, (b) FTSE 350 companies, (c) the FRC, (d) Big 4 firms, (e) Mid Tier firms, and (f) UK industry bodies. The views expressed below are drawn from parties' responses to the public consultation on the Remedies Notice, hearings with 25 CFO/FDs and ACCs (the 'case studies') and a questionnaire sent to investors. Details of the views expressed are set out in Appendices 1.1 and 3.1.

Investor community

- 3.24 On the appropriate time frame, the views of investors were mixed. Many of the responses were in support of ten years (in particular, AXA Investment Managers, [X], Hermes, [X], Royal London Asset Management and [X]). Others favoured a shorter period (in particular, Baillie Gifford, National Association of Pension Funds, Newton Investment Management and a coalition of six investors and a body representing 56 local authority pension funds⁵⁷). Some (Legal and General Investment Management (L&G)) favoured a longer period.⁵⁸ Views were also mixed on whether the obligation should be mandatory or on a 'comply or explain' basis.

⁵⁷ See Appendix 3.1, the footnote to paragraph 78.

⁵⁸ Investor questionnaire response.

FTSE 350 companies

- 3.25 We received responses to our Remedies Notice from 13 FTSE 350 companies. None favoured a remedy that would require more frequent tendering than that required by the new FRC provisions (ie every ten years). Most said that the new FRC provisions should be allowed time to take effect before any further changes were made. Some said that tender processes could be expensive and disruptive for companies. None supported an open-book approach. Several said that an open-book process would not significantly reduce company or firm costs and they were concerned that confidential information would be more widely available.
- 3.26 In the recent case studies, most interviewees considered the new FRC provisions to be a healthy discipline. Many opposed making tendering mandatory and argued that ACs should take decisions on the timing of tender processes after calculating the costs and risks involved. Some interviewees were prepared to see shorter times between tender processes. A few had no issue with the proposal for mandatory tendering and considered that the key issue would be their frequency.
- 3.27 Some interviewees considered that more frequent tendering would lead to fewer firms being available to compete for the engagements. One respondent said that with several firms going out to tender around the same time, fewer well-qualified firms and teams would be available for new engagements. Another said that more frequent tendering could discourage some of the Big 4 firms from bidding in particular tender processes.
- 3.28 Respondents did not identify significant efficiencies from more frequent tendering. However, one ACC said that more frequent tendering might lead to a more efficient process over time. Another thought that the costs to audit firms arising from frequent tendering would be passed on to the audit firms' existing clients. Some saw a danger

that greater frequency would lead to tender processes becoming a ‘box-ticking’ exercise.

The FRC

3.29 The FRC said that the new provision in the UK Corporate Governance Code 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 might increase as non-Big-4 firms find their existing audits put out to tender.⁵⁹

3.30 The FRC would be concerned about a mandatory requirement to tender. It said ‘comply or explain’ was an important facet of the UK governance regime. The latest survey suggested a 90 per cent compliance rate with the UK Corporate Governance Code. 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 inappropriate years contrary to investor’s interests.⁶⁰

Big 4 firms

3.31 The Big 4 firms argued that tendering of audit engagements would become a regular feature of the market under the new FRC provisions; and that these provisions should be given an opportunity to work before being dismissed as inadequate by us.

3.32 The Big 4 firms said that the new provisions were already having an effect on the frequency of tendering processes (see paragraph 3.63). The Big 4 firms expected a high level of compliance. The ‘comply or explain’ principle was said to be a central

⁵⁹ FRC response to the provisional findings and Remedies Notice, p2.

⁶⁰ *ibid.*

feature of the UK's corporate governance landscape. Deloitte considered that a decision by an AC not to go out to tender in a given (mandatory) 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.

3.33 The Big 4 firms supported the 'comply or explain' provision. They said that requiring tender processes to occur at designated times (or requiring tendering at intervals that did not give ACs sufficient flexibility on the timing) could force companies to incur the costs and distraction of a tender process 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. In these circumstances, it would be expected to go out to tender in the following year (see also paragraph 3.64 below).

3.34 The Big 4 firms said that going out to tender more frequently than every ten years would be costly for companies and firms, and that audit firms might be less willing and/or able to devote the same level of resources to each tender process or they might be less willing to accept invitations to tender. In particular, the Big 4 firms said that being invited to tender would no longer always signal to the bidders that the company was seriously considering switching auditors and that this might reduce the incentive for rival audit firms to participate in tender processes if the incumbent audit firm was seen to have an advantage (as it would not have to incur the costs of 'getting up to speed' and the company would not have to bear similar costs of transition).

3.35 KPMG said that it was highly unlikely that the profession as a whole would be able to hire the most highly skilled, experienced and senior resources needed to meet the

additional demands from more frequent tendering processes, particularly in the case of the most significant and complex FTSE 350 clients and those clients with specialist requirements that required particular expertise (ie certain clients in the financial services industry).

3.36 The Big 4 firms said that there was no basis for expecting that the costs of tendering processes would be reduced with increased frequency. KPMG said that audits were bespoke and so there were very few, if any, economies of scale associated with the participation in audit tender processes. It was also said that a reduction in the resources devoted to tendering processes by companies would be likely to undermine companies' incentives to ensure a high-quality tender process. The Big 4 firms said that an obligation to go out to tender every five or seven years would adversely affect competition between these set intervals.

3.37 With the exception of Ernst & Young LLP (EY), the Big 4 firms were not supportive of an open-book process. They said that access to the existing auditor's working file could result in a breach of client confidentiality, stifle innovation by audit firms and compromise the benefit of a 'fresh approach'. They also said that an open-book approach would increase bidding costs for firms, given the resources required to review the files, and that there would be costs for companies in assembling and disseminating the information. EY did not expect an open-book approach to reduce the costs of tendering processes.

Mid Tier firms

3.38 With the exception of BDO, the Mid Tier firms supported mandatory tendering at least every ten years. This was said to be widely supported by other investors and stakeholders. Mid Tier firms expressed concerns, however, that mandatory tendering

might not provide many real new opportunities for non-Big-4 firms unless accompanied by other measures.

- 3.39 BDO supported mandatory tendering (and AEP rotation) at least every seven years. It said that more frequent tendering provided a regular opportunity for ACs to step back and reflect on the quality and independence of the incumbent auditor, and increased the ability for companies to make an informed choice of auditor which would increase companies' bargaining power and the incentives for auditors to compete.⁶¹ BDO also said that it would encourage greater differentiation between audit firms, as firms sought to distinguish themselves by their audit service, approach and philosophy, not just by price.
- 3.40 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 going out to tender. GT said that it was almost inevitable that, with more frequent tendering and with companies and audit firms becoming more familiar with efficient and effective tendering processes, audit firms would be forced to focus their efforts in the tender process solely on audit quality and not the other matters that were often part of the tender process at present. GT also said that audit firms would become more selective in accepting an invitation to tender.
- 3.41 The views of Mid Tier firms in relation to an open-book process were mixed. BDO would welcome an open-book process.⁶² Kingston Smith said that it could see benefits in an open-book process but was not convinced that this would reduce costs.⁶³ Crowe Clark Whitehall (CCW) had serious reservations about the

⁶¹ [BDO response to the Remedies Notice](#), paragraph 1.6.3.

⁶² *ibid*, paragraph 1.5.3.

⁶³ [Kingston Smith response to the Remedies Notice](#), section 1.

appropriateness of an open-book process as it could stifle innovation and would not significantly assist the process.⁶⁴

UK industry bodies

3.42 We received responses from various bodies representing the accountancy profession and FDs, general counsel and company secretaries of FTSE 100 companies. We also received submissions from the Confederation of British Industry (CBI) and Association of British Insurers (ABI). All submissions supported the new FRC provisions.

Assessment of effectiveness

3.43 In our assessment of effectiveness we draw primarily upon the evidence provided by our provisional findings, submissions made in response to the Remedies Notice, the remedies hearings, and the further case studies conducted with ACCs and FDs.

3.44 We consider first the likely effect of the new FRC provisions as these form part of the background against which we assess the effectiveness and proportionality of the proposed remedies. See paragraphs 3.51 to 3.66.

3.45 Second, we consider the costs to firms and companies of implementing the remedy in paragraphs 3.67 to 3.99. These are relevant to the assessment of its effectiveness because the Big 4 firms have argued that an obligation on companies to go out to tender more frequently than required by the new FRC provisions (and on an open-book basis) would be ineffective given the costs involved. In particular, they said that, because of the costs involved for firms and companies, a requirement for more frequent tendering could undermine the incentives of firms to compete intensely for

⁶⁴ [CCW response to the Remedies Notice](#).

engagements when put out to tender and/or could result in scarce resources being diverted from conducting audits (see paragraph 3.34).

3.46 We note that the Big 4 firms put much the same points to the FRC in its consultation on proposed changes to the UK Corporate Governance Code and Guidance on ACs, and that the FRC reported that the Big 4 firms did not support proposals for tendering every ten years on a comply or explain basis.^{65,66} Whilst we recognize that for those affected, understanding how they and others would respond to change can often be difficult, it appears that having had the opportunity to consider carefully their response to the changes to the UK Corporate Governance Code the Big 4 firms now consider these to be manageable. Indeed, the Big 4 firms have generally welcomed the requirement for companies to go out to tender every ten years, on a comply or explain basis, in recent submissions to the CC. We have listened carefully to what the audit firms have said in relation to a requirement to go out to tender every five years, but consider that on balance we can expect companies and firms to be able to respond to a requirement to tender every five years in ways that would be in the interest of shareholders.

3.47 Third, we consider the effect of a remedy that requires tendering every five years may be expected to have on the intensity of competition and audit quality in paragraphs 3.100 to 3.138. In particular, we consider the arguments made by the Big 4 firms that effectiveness would be undermined by the costs associated with the remedy.

⁶⁵ See the FRC's Feedback Statement of September 20102—www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Feedback-statement-on-UK-Corporate-Governance-Code.aspx.

⁶⁶ The Big 4 firms are reported to have suggested other ways of alleviating the perception that long-serving auditors may lack independence. The arguments put forward against tendering included: that existing protections such as audit partner rotation were sufficient; that it could be costly and disruptive; that there is limited choice in some sectors; and that it might lead to pressure on audit fees and adversely affect quality.

- 3.48 Finally, we consider the effectiveness of a remedy that would give ACs the power to request that the incumbent auditor gives them access to specified parts of audit file for disclosure to rival bidders, in paragraphs 3.139 to 3.145.
- 3.49 In our assessment we recognize that any remedy adopted would apply to all FTSE 350 companies although the costs imposed on companies and the benefits derived will differ between companies. In particular, the costs associated with tender processes will be greater for some companies than for others.
- 3.50 We would expect this remedy to result in more switching of auditors than would otherwise be the case. We do not, however, consider in the assessment of Remedy 1 the costs and benefits associated with switching since we can reasonably assume that a company would not switch unless it expected that the benefits to be had would exceed the costs of doing so.

The likely effect of the new FRC provisions with regard to the AEC we provisionally found

- 3.51 In the provisional findings (see Appendix 3, ('Competition Commission first survey results'), Table 16) we found that 40 per cent of FTSE 350 companies had either last gone out to tender more than ten years ago or had never tendered the audit. We also estimated that for the period 2001 to 2010, there were on average around ten tenders a year for FTSE 350 audit engagements.⁶⁷
- 3.52 Were all FTSE 350 companies to 'comply' with the new provisions of the UK Corporate Governance Code we could expect an average of at least 35 tenders a year. Initially though, taking into account the phasing-in arrangements, we would

⁶⁷ Provisional findings, paragraph 7.21.

expect a higher rate of tenders given the number of FTSE 350 companies that have not gone out to tender for more than ten years.

3.53 The rate of companies going out to tender will depend on how, in practice, companies interpret the possibility not to 'comply' and rather to 'explain' and in particular, the circumstances in which companies consider it acceptable to 'explain' rather than 'comply' and the number of years for which it would be acceptable to take advantage of this possibility. Since these provisions have only been in place since 2012 the available information on this point is limited. The evidence we have suggests that there are some differences of view on this question. We summarize such evidence from (a) the FRC; (b) FTSE 350 companies; and (c) audit firms.

- *The FRC's expectations*

3.54 The ability to 'comply or explain' does not just apply to the new FRC provisions in relation to tendering of audit engagements. Rather it is an approach that the FRC has adopted more generally in the development of the UK's corporate governance regime.

3.55 Paragraph 3 of the UK Corporate Governance Code states that:

An alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result. In providing an explanation, the company should aim to illustrate how its actual practices are both consistent with the

principle to which the particular provision relates and contribute to good governance.⁶⁸

3.56 The FRC also said that there was general agreement that explanations should be full and include reference to context and coherent rationale. They should show how the company was fulfilling the relevant principle of the Code and also indicate whether deviation from its provisions was time limited. Ideally explanations should be sufficiently full to meet the needs of those shareholders who could not simply call up the company and ask for information, but larger shareholders also saw them as the foundation for further dialogue that should engender trust.⁶⁹

3.57 The FRC said that the 'comply or explain' principle gave authority to shareholders, because they had to make a decision about whether or not to accept the explanation if the company chose not to comply, and this had enabled the FRC to go further than if it had been setting hard rules. The principle gave companies time to adapt.⁷⁰ The FRC also said that it would not regard as acceptable a situation where a company was explaining year after year, and would hope that the shareholders would not regard it as acceptable. The FRC considered that an explanation should be related precisely to the circumstances of the company at the time and not be general in nature. The FRC anticipated that a company would set about making sure that if it was inappropriate to go out to tender in year one it would be in a position to do so by year three and was able to explain in year one how it was going to get there.⁷¹

⁶⁸ FRC, [The UK Corporate Governance Code](#) (September 2012), paragraph 3

⁶⁹ FRC, [What constitutes an explanation under 'comply or explain'](#), *Report of discussions between companies and investors*, February 2012.

⁷⁰ [Summary of response hearing with the FRC](#), paragraph 12.

⁷¹ *ibid*, paragraph 28.

3.58 The FRC referred⁷² to the findings of a GT survey.⁷³ GT was reported to have found that: 50 per cent of FTSE 350 companies reported full compliance with the UK Corporate Governance Code; two-thirds of those that did not comply explained with a meaningful level of detail; and one-third explained but with less detail. There were no cases of a company not complying and failing to provide an explanation. GT also found that most instances of non-compliance related to only one or two provisions of the Code and consequently that overall FTSE 350 companies complied with 96 per cent of the aggregate Code provisions that applied to them.

3.59 With regard to the new provisions, the FRC considered that it would be acceptable for a company to explain rather than comply in certain commercial circumstances such as: a change in the FD; a level of risk in the year concerned that made it particularly relevant for the auditor to understand the history; on the company being engaged in a takeover. The FRC also said that there might not be a viable alternative auditor and in these circumstances the company ought to work with more than one firm to try to encourage the firms to get the resources to be able to bid.⁷⁴

- *Companies' expectations*

3.60 In the recent case studies (see paragraph 3.23 above), many of the FDs and ACCs we spoke to expected that some companies would explain for a year or so but would then comply. The CFO of Company V, for example, said that 'comply or explain' led to compliance in the vast majority of cases⁷⁵ and the ACC of Company Q said that 'comply or explain' was the basis of good governance.⁷⁶ However, there was also a view that in practice there was likely to be a range of responses from companies and

⁷² See the FRC's *What constitutes an explanation under 'comply or explain', Report of discussions between companies and investors*, February 2012.

⁷³ GT 2011 Corporate Governance Review.

⁷⁴ *Summary of response hearing with the FRC*, paragraph 29.

⁷⁵ *Case Study V*, paragraph 17. See also *Case Study N*, paragraph 17; *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).

⁷⁶ *Case Study Q*, paragraph 12.

at least one ACC, who was organizing a tender process, suggested that the company might wish to explain for a while into the future.

3.61 Generally, the interviewees agreed that, regardless of the interval between tender processes, flexibility on the precise timing of a tender process was necessary to avoid going out to tender at times that were not convenient for the company.⁷⁷ The ACC of Company L gave as examples acquisitions or changes in functional and reporting systems.⁷⁸ Several interviewees suggested that a tender process could be linked to the rotation of the AEP.

3.62 In its response to the Remedies Notice, SABMiller said that it would be inadvisable to tender the audit when there was a new CFO or ACC or if a company had recently been involved in any major corporate activity (see Appendix 1).

- *Auditors' expectations*

3.63 The Big 4 firms said that they would expect a high rate of compliance and that the new provisions were already having an impact on tendering and switching activity:

(a) Deloitte gave HSBC, Schroders, RSA and BG as examples of recent more frequent tender activity. These are said to have all gone out to tender following long periods of tenure. Deloitte also said that a number of its clients had already told it that they would be going out to tender as a result of the new requirement.⁷⁹

(b) KPMG said that it was aware of 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 RSA, Schroders Plc and ITV Plc. 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

⁷⁷ See, for example, [Case Study K](#), paragraph 25.

⁷⁸ [Case Study L](#), paragraph 28.

⁷⁹ [Summary of response hearing with Deloitte](#), paragraph 6.

Sciences Plc, Foreign Colonial Investment Trust Plc and Ladbroke's Plc had all recently stated they would tender their audits within the next three years.⁸⁰

(c) PwC said that, in its experience, the implications of the new tendering regime were on the agenda of most ACs (over 20 FTSE 350 companies have said as much in the annual reports for 2012) and that HSBC had announced a tender process and BG, RSA and Cairn Energy had decided to switch auditor following a tender process.⁸¹

3.64 The Big 4 firms considered that the circumstances in which it would be acceptable to 'explain' would be limited and short-lived. In particular:

(a) Deloitte said that it expected that it would be acceptable for a company to explain for one year, possibly two years, and only rarely longer. Acceptable circumstances might be a major transaction, a big change of management, or if something disruptive was happening to the organization.⁸²

(b) EY said that the circumstances in which it would be acceptable to explain would be a major event such as a merger, a disposal or a major acquisition. EY said it was difficult to envisage a circumstance where that event would not have moved on a year or two down the road.⁸³

(c) When asked for examples of when it would be appropriate to 'explain' rather than 'comply', KPMG mentioned a major transformational acquisition or disposal, initial public offering, some form of new build, a major change in the finance function, or the departure of the FD. KPMG said that in these circumstances changing auditors at the same time would involve some risk around the assurance

⁸⁰ KPMG response to the Remedies Notice, paragraph 3.1.4.

⁸¹ PwC response to the Remedies Notice, paragraph 3.13.

⁸² Summary of response hearing with Deloitte, paragraph 6.

⁸³ EY Remedies Hearing..

processes.⁸⁴ It would also be hugely inefficient to divert management time towards an audit tender process at such a time.⁸⁵

(d) PwC suggested, based on its experience of companies ‘explaining’ a delay in AEP rotation, that the opportunity to explain provided flexibility to deal with unforeseen circumstances and that the circumstances in which companies might decide to ‘explain’ would be very limited (examples given were major M&A activity, a recent change in Chief Executive or CFO, or major system changes) and that such circumstances would be limited in duration to a year, on rare occasions, or two.⁸⁶

3.65 KPMG said that mandatory tendering (as compared with a ‘comply or explain’ regime) assumed that all FTSE 350 companies could be treated the same, regardless of their size or complexity, when in fact the size and complexity of a company had an important bearing on the appropriate timescale for a tender process. It also said that, under mandatory tendering, the lack of a comply or explain provision implied that individual company circumstances, such as a change in company leadership or a critical financial situation, could be overlooked in order to comply with a rigid timetable.⁸⁷

3.66 In summary, it appears to us that there is a general expectation that the level of compliance with the new FRC provisions will be high (see paragraphs 3.54 to 3.65). If this turns out to be the case, the new FRC provision would be expected to result, in a steady state, in a rate of around 35 tender processes being held a year. However,

⁸⁴ Summary of response hearing with KPMG, paragraph 44.

⁸⁵ KPMG response to the Remedies Notice, paragraph 3.2.1.2.

⁸⁶ Summary of response hearing with PwC, paragraphs 36 & 37.

⁸⁷ Summary of response hearing with KPMG, paragraph 26.

KPMG expressed a view that some companies might seek to ‘explain’ more often and for longer.⁸⁸

The costs associated with going out to tender for audit services every five years

3.67 We now consider the arguments and evidence in relation to the additional costs that would be incurred were companies required to go out to tender every five years. We consider (a) the incentives and scope for tender processes to become more efficient. In light of this, we consider the additional costs to (b) firms and (c) companies of a requirement to tender every five years.

- *Incentives and scope for companies and firms to be more efficient in participation in tender processes*

3.68 We think that the costs associated with tender processes are largely determined by the companies and firms involved. We found in the provisional findings that companies specify the parameters of tender processes.⁸⁹ The costs will also depend on how many firms are invited to participate in the process and which firms decide to accept. In our assessment of the effectiveness of the remedy (see paragraphs 3.100 to 3.138), we consider how going out to tender every five years may be expected to affect the design and competitiveness of the process, including the willingness of firms to participate when invited to do so. We consider here the evidence that more frequent tendering would be expected to result in firms and companies becoming more efficient.

3.69 We consider that companies would have an incentive to invest more time and effort into considering how the process may be managed more efficiently if they must conduct tender processes every five years. We would also expect a company to consider both its own costs and firms’ costs, since firms’ cost calculations may affect

⁸⁸ Summary of response hearing with KPMG, paragraph 27.

⁸⁹ See provisional findings, Appendix 23 (‘The tender process’), paragraphs 3 and 26–38.

firms' willingness to participate. We also consider that firms would have incentives, if participating in more tender processes, to maximize the efficiency of their internal processes.

- 3.70 In our case studies (see paragraph 3.23) we discussed with FDs and ACCs the scope for tender processes to be conducted more efficiently. Based on these interviews it appears to us that the key elements to an efficient tender process are (a) that companies give sufficient attention at the start to the design of the process and (b) that access to senior management is specified and controlled.
- 3.71 Company W had used a procurement consultancy to manage the process including arranging appointments with management and collating responses to proposals against specified criteria. In this case, the company was an international business, regional FDs met with the bidding firms and they were asked for their assessment of the proposals. Company K used its internal procurement function to assist with structuring the process and to ensure adherence to the relevant rules. Some companies used data rooms to facilitate the efficient dissemination of information to the bidding firms.
- 3.72 Documents recently submitted by the firms provide direct evidence on the scope for firms to achieve efficiencies. In particular, [REDACTED]. Whilst these submissions do not provide details on how such efficiencies might be achieved, this shows that some Big 4 firms see that there is scope for efficiencies in their processes and we consider that to be evidence that there is scope for such efficiencies.
- 3.73 KPMG said (paragraph 3.36) that audits were bespoke and so there were very few, if any, economies of scale associated with the participation in audit tender processes and so the cost per process was likely to remain unchanged regardless of the

number in which an audit firm participated.⁹⁰ Whilst we agree that tender processes are bespoke the recent submissions provide evidence on scope for efficiencies.

3.74 BDO said that whilst FTSE 350 companies were generally used to conducting tender processes for other professional services, such as legal services, they tended to have less experience of conducting tender processes for their statutory audit. BDO considered 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.

- *Impact on firms' costs*

3.75 [X] estimated the cost to firms of participating in a FTSE 350 tender process, excluding large financial institutions, to be in the range of £[X] to £[X] for staff costs and £[X] to £[X] including expenses (at 2011 scale rates). For a large financial institution these figures were £[X] and £[X] respectively. [X] also said that its current expenditure on the [X] tender was over £[X].

3.76 KPMG estimated the additional cost of participating in tender processes every five or seven years to be £60 million or £26 million per year, respectively. These were based on a cost to audit firms for each tender process of between approximately £0.99 million and £2.4 million (assuming participation of three firms). These estimates were said to assume the current level of effort and resource on the part of audit firms.⁹¹ KPMG also said that it would need to increase the resources of its bid team that supported tenders and proposals. Based on its costs, KPMG estimated an additional cost attributable to increasing bid team resources for the largest four audit

⁹⁰ KPMG response to the Remedies Notice, paragraph 3.2.2.13.

⁹¹ KPMG response to the Remedies Notice, paragraph 3.2.2.5.

firms of £[redacted] million and £[redacted] million under mandatory tendering on a seven- and five-year basis respectively.⁹²

3.77 We consider these arguments in detail in Appendix 3.2.

3.78 In the provisional findings we set out our findings on the costs firms had incurred in participating in FTSE 350 tender processes.⁹³ We estimated that senior managers, directors and partners accounted for the largest proportion of time spent preparing for the tender process. In particular, partners accounted for 30 and 35 per cent of the total time spent preparing a submission. We calculated the costs of the staff time allocated to a tender process using scale rates (which we would expect to over-estimate the costs). The estimated costs ranged from £[redacted] to £[redacted] million with averages of £[redacted] and £[redacted] for [redacted] and [redacted] respectively.

3.79 We estimated staff costs in the provisional findings using scale rates, but expected that this approach would result in a considerable overestimate. The opportunity costs to the firm of staff employed on tender processes would be determined by (a) the cost to the firms of employing additional resources to provide capacity to participate in tender processes and/or (b) any forgone income where staff allocated to a tender process would otherwise have been allocated to client work.

3.80 In Appendix 3.2 we set out a comparison of scale rates with staff costs. These figures show that scale rates exceeded staff costs by [redacted]. In the provisional findings we presented results on the revenue recovery rate (RRR) achieved for audit engagements which provides a measure of how fees earned have compared with scale rates (see the provisional findings, Appendix 5 ('Descriptive statistics'), Figure 21). These results indicate that [redacted] achieved an average RRR on its FTSE 350 audit engage-

⁹² KPMG response to the Remedies Notice, paragraphs 3.2.2.9 & 3.2.2.10.

⁹³ See provisional findings, Appendix 24 ('Analysis of tender data').

ments over the period 2006 to 2011 of around [X] and [X] around [X] per cent. [X] estimated the opportunity cost of time charged to a tender process at [X] per cent of scale rates.

3.81 If we applied these discounts to the figures given above (see paragraph 3.78), this would give an average staff cost of participating in a tender process of £120,000 and £225,000 (in 2005 prices).

3.82 These figures would suggest a cost to firms of an additional 35 tender processes a year of £12.6 million to £23.6 million a year, assuming that on average three firms participated in each. The average cost per additional tender process would be in the range £360,000 to £675,000. As presented in the provisional findings, all figures are in 2005 prices. If these were to be presented in 2011 prices they would 20 per cent higher.

3.83 We consider that these estimates based on the cost to firms of the staff time allocated to past tender processes will overstate the incremental costs to firms of a remedy that would require companies to go out to tender every five years. In particular:

(a) as explained above (see paragraphs 3.68 to 3.73), we would expect that a requirement to go out to tender every five years would create incentives for firms and companies to invest in realizing efficiencies in the tender process;

(b) we note that companies will often hold tender processes at quiet periods in the audit cycle, ie when an audit has just been completed. One reason for this is to give the winner of the tender, if not the incumbent, time to get up to speed. Given the concentration of company year-ends around December and March, these periods will also be quieter periods for firms. The opportunity cost of audit staff will therefore be lower at these times; and

(c) we consider that the costs to a firm of the time allocated to tender processes will not all be incremental costs to the firm. In particular, we would expect some of these resources to be diverted from marketing activity (see paragraph 3.84 below).

3.84 We consider that increased tendering is likely to result in a diversion of resources, particularly partner time, from marketing activities. In the provisional findings we found that partners accounted for around 30 to 35 per cent of the time spent preparing submissions (see the provisional findings, Appendix 24 ('Analysis of tender data', paragraph 33). We also found that about 20 per cent of audit partner time (excluding those with a dedicated marketing role and assuming a 40-hour working week) is spent on marketing activities (see the provisional findings, Appendix 29, ('Economies of scale in operating costs'), Table 7). The main objectives of these activities appeared to be identifying potential audit clients, raising prospective client awareness of the firm's capabilities and developing relationships with potential client staff (see the provisional findings, Appendix 16). We consider that activity aimed at encouraging companies to go out to tender would not be necessary if companies were required to conduct a tender process every five years and that the tender processes would provide regular opportunities for firms to demonstrate their capabilities.

3.85 The Big 4 firms have said that more frequent tendering would result in higher audit fees, ie the costs incurred by firms in participating in additional tenders would be passed onto their clients.⁹⁴ PwC said that it would not have the same incentives to

⁹⁴ [KPMG response to the provisional findings](#), paragraph 2.3.3.6.

offer companies the relative short-run reductions in fees that it had offered in the past.⁹⁵

3.86 Whilst we are not persuaded that the Big 4 firms currently offer companies short-term discounts to encourage switching,⁹⁶ we accept the general point that the lifetime costs of an engagement will be a factor in determining the price and, all else being equal, a regulatory intervention that raised the costs to all firms may be expected to result in higher fees.

3.87 With more intense competition encouraged by mandating tendering every five years, firms may not be able to pass higher costs on to customers. More importantly, whether audit fees would increase is a question of how any additional resource costs would be shared between firms and FTSE 350 companies and their shareholders. The question of the extent to which firms might be able to pass on higher costs does not have a bearing on the quantum of costs.

- *Additional costs to companies of going out to tender every five years*

3.88 KPMG said that the CC's analysis showed that past tender processes launched by FTSE 350 companies lasted between six weeks and three months. During this time, there may be up to 20 meetings with potential bidders to outline the audit requirements, in addition to the time spent reviewing proposals and presentations, and providing feedback on the outcome of the tender process to bidders. The committee tasked with selecting the audit firm in a tender process generally included the company FD, ACC, members of the AC and the Chief Executive, but may also include other relevant individuals such as the financial controller. KPMG said in its experience the whole process also included many other key management personnel

⁹⁵ PwC response to the provisional findings and remedies notice, Annex 1 (Market Outcomes), paragraph 20b.

⁹⁶ www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/130617_review_of_evidence_price_effects_of_switching.pdf.

from across the business and was certainly not restricted to the finance function.⁹⁷

We consider this statement to be consistent with the evidence provided by the case studies.

3.89 KPMG estimated that the opportunity cost to a FTSE 350 company of running a tender process was on average approximately £440,000 per process, and could even be as high as £980,000. This calculation was based on European Commission estimates of the number of working days required by management to conduct a tender process, multiplied by fee rates of senior management professionals provided by Income Data Services (IDS). In particular, KPMG used hourly remuneration rates based on salaries of FD or equivalent positions in the FTSE 350. Based on these figures, KPMG estimated the total additional cost to companies' management from running additional tender processes would, compared with the FRC changes to the UK Corporate Governance Code already implemented, be between £6.6 million and £15.4 million per year (for seven-year and five-year intervals, respectively).⁹⁸

3.90 PwC said that substantial costs would be incurred by companies. PwC noted our findings that: running a tender process can be onerous for some companies; that the cost, principally in management time, appears related to the size, complexity and geographic spread of the company; and that senior management time is required.⁹⁹

3.91 Since publishing our provisional findings we held hearings with FDs and ACCs of 11 FTSE 350 companies that had recently held tender processes for their audit engagement. The results of these case studies are summarized in Appendix 1.1. We found that the main cost to a company of conducting a tender process is the

⁹⁷ [KPMG response to the Remedies Notice](#), paragraph 3.2.4.2.

⁹⁸ [ibid](#), paragraph 3.2.4.4.

⁹⁹ [PwC response to the Remedies Notice](#), paragraph 3.28.

opportunity cost of the time spent by senior management in designing the process and participating in the process.

- 3.92 We cannot put a reliable monetary value on this time. However, in the case study interviews we explored with FDs and ACCs the following: who from the company would typically be involved in a tender process; at what stages in the process they would be involved; and the time they would be expected to commit.
- 3.93 The responses indicate that costs vary between companies. The amount of time individuals would be expected to commit and the number involved in the process will typically be higher where the company is more complex. The size of the company in itself appears to be less important.
- 3.94 The tender process followed by Company N was fairly typical. It involved at least 30 initial meetings between the bidding firms and staff. The meetings lasted about an hour to an hour and a half, with the firms having to provide agendas and CVs in advance. The firms provided written submissions, which were read and marked by all AC members, the CFO and other relevant management executives. Finally the firms made oral presentations to a selection panel, comprising the ACC and executive management, including the CEO, CFO, Chairman and others such as the Group Financial Controller and General Counsel.
- 3.95 The CFOs and ACCs from at least six companies interviewed thought that the opportunity cost to companies of going out to tender was manageable, if sometimes onerous, and could be calculated in advance. This view was largely based on recent experience of conducting a tender process. Several challenged any notion that holding a tender process was unduly disruptive of other executive activities. The FD of Company T, for example, said that the tender process did not cause significant

disruption to the company, and the ACC considered that the financial and opportunity costs in terms of management time were exaggerated and that the costs could be minimized by a well-designed tender process (See Appendix 1.1, paragraph 26).

3.96 However, a few of those interviewed said that going out to tender was time-consuming since running the process involved executive staff in considerable additional work at a cost of their normal duties. The FD of Company S, in particular, had found the process to be very time-consuming for himself, the senior members of his finance team (approximately seven to eight people) and senior business heads. He said that the firms had unfettered access to him and his finance team. The ACC said that the time that would be spent on the tender process had been considerably underestimated at the outset and that the accounting department had borne the brunt of this, having to brief two new firms on the company's systems and activities.¹⁰⁰ Barclays said that tendering processes involved significant disruption to business activities of multinational companies due to their scale, depth and geographical spread. It estimated that the cost of a single tender process in terms of man hours for a group the size of Barclays would involve in excess of 200 staff with a total time spent in excess of 1,000 man days over an estimated project time of two years. Whilst there were, undoubtedly, some common steps to all tender processes, this would need to be multiplied by the number of firms invited to tender given that each firm would probably have separate information requirements (especially if an 'open-book' basis were adopted, allowing tendering firms to access all relevant information from the company as part of the tender process rather than transition process).¹⁰¹ See also Appendix 1.1.

¹⁰⁰ Case Study S, paragraph 5. See also Appendix 1.1, paragraphs 26–33.

¹⁰¹ Barclays response to the Remedies Notice.

- 3.97 We asked those individuals concerned to estimate the time they had spent on various stages in the tender process. Their responses varied widely, from three to four days to three to four weeks, generally over periods ranging from six weeks to several months (see Appendix 1.1, paragraphs 30 to 32).
- 3.98 We accept that there will be times when the cost to the company of conducting a tender process would be particularly high. These will be circumstances when it would not be in the interests of shareholders for the Chairman, CFO, FD or the ACC to be distracted from dealing with events of acute commercial or strategic importance to the business. The circumstances when this might be the case are discussed above (see paragraphs 3.33 and 3.64). The expectation was that such events would be infrequent and short-lived. They may, however, not be predictable. Our provisional view is that companies should be able delay a tender process by up to two years on a 'comply or explain' basis. We consider that this would provide companies with the flexibility to deal with unforeseen circumstances or major developments (eg major changes in group structure or top management) in which it would not be the interests of shareholders for a company to run a tender process because the opportunity costs of management time would be particularly high.
- 3.99 With regards to KPMG's estimates of the costs to companies, we are not persuaded that salaries for FTSE 350 FDs or equivalent positions provide a reliable basis for estimating the opportunity cost of management time involved in conducting a tender process. We consider that the opportunity cost to the company of the time required to conduct a tender process will depend on the other demands on the time of those involved at the time the tender is taking place. The individuals involved will have competing demands on their time. In the normal course of events, however, we would expect them to be able to manage their time to run a tender process effectively as a part of their portfolio of responsibilities.

The effectiveness of requiring tendering every five years

3.100 In this section we consider the effectiveness of a requirement for companies to go out to tender every five years in addressing the AEC. As explained above, we consider that tendering every five years would focus the competitive process (see paragraph 3.17). We consider that this would be desirable for several reasons given the better information provided by the tender process, the greater transparency of the appointment decision following a tender process, the significant role of the AC, in consultation with other board members, in the selection process, and increased accountability to shareholders (see paragraphs 3.10). We consider that these benefits from more frequent tendering would be greater in conjunction with the other measures that we are proposing as part of our overall package of remedies to increase the influence of the AC and encourage greater shareholder engagement.

3.101 However, Big 4 firms and some FTSE 350 companies said that a requirement to go out to tender every five years could be counterproductive. In particular they said that the result could be to undermine the incentives that firms currently had to participate in, and compete intensely for, tendered engagements. Firms and some companies said that firms' resources might be a constraint on their ability to participate in tender processes. It has also been said that more frequent tenders might reduce companies' incentives to invest time and effort in conducting tenders, compared with the historical position (see paragraph 3.34).

3.102 The Big 4 firms also said that there would be a cost to shareholders from more frequent tendering from a reduction in audit quality because:

- (a) firms will not be as willing to participate in tenders, resulting in a less competitive process;
- (b) firms will participate but will be less willing or able to allocate the same resources to the tender process;

(c) the tender process specified by the company may not be as thorough as in the past; and

(d) more frequent tendering would have an adverse effect on the bargaining position of companies between tenders.

3.103 We recognize the need to consider how a requirement to go out to tender more frequently would affect the incentives faced by companies and incumbent and rival firms both when engagements are tendered and between tenders. We consider the key factors in this assessment to be the effect that more frequent tendering may be expected to have on the incentives faced by:

(a) firms to compete in tender processes;

(b) firms to invest in their capabilities;

(c) companies in the conduct of tender processes; and

(d) incentives faced by incumbent firms between tender processes.

3.104 We assess these in turn below.

- *The incentive of firms to compete in tender processes*

3.105 In the provisional findings we found that that the majority of FTSE 350 companies considered that they had a choice of at least three Big 4 firms, that only rarely would firms decline an invitation to tender and that potential conflicts of interests were frequently resolvable (see the provisional findings, paragraph 9.237). We also found that firms had an incentive, having decided to participate in a tender process, to take the process seriously and make best efforts to impress the client (see the provisional findings, paragraph 9.239).

3.106 We considered whether that would remain the case with an increased frequency of tendering processes, in particular whether: (a) firms' propensity to bid would be

affected; (b) conflict issues would reduce numbers of firms bidding; (c) firms would have insufficient resources to participate in all tender processes; and (d) firms would expend less effort when bidding.

◦ *Firms propensity to bid*

- 3.107 The Big 4 firms said that a requirement for FTSE 350 companies to go out to tender more frequently than required by the new FRC provisions could adversely affect the intensity of competition in tender processes. PwC said that it might be less willing to accept invitations to tender as the decision to go out to tender would no longer be a signal of dissatisfaction and so the company might have no intention of switching (see also paragraph 3.34 above). KPMG said that there would be less incentive to participate if the incumbent firm was seen to have an advantage. EY and KPMG argued that firms might be less able or willing to devote the same level of resources to tender processes.
- 3.108 As stated above, Big 4 firms argued that only rarely did they decline invitations to tender, suggesting that these firms have not routinely undertaken an exercise of assessing whether to participate in tender processes when invited to do so. Nevertheless we accept that this may be a reflection of the low frequency of tender processes in the past, and that if firms were required to participate in tender processes more frequently this could change. In particular, firms may be more strategic in their approach to participating in tender processes, given the opportunity cost of resources required to bid.
- 3.109 In principle, we consider that that the expected gains from participating in a tender process would be the primary consideration for firms in deciding whether or not to participate. We acknowledge that the propensity for companies to switch auditor following a tender process is, on average, likely to be lower when the tender has not

been voluntary, and that the expected pay-off from participation would therefore be lower.

3.110 However, we consider that the gains from winning FTSE 350 audit engagements will continue to give incentives to firms to bid. Going out to tender every five years would not affect the scope of the engagement. Rival firms bidding for an engagement would know that if they succeed in winning the tender process, as the incumbent they would be well placed to win the subsequent tender in a later year if the client had been satisfied with their performance. As KPMG has recognized, in these circumstances, the incumbent will have an advantage. The retention and gaining of audit clients will continue to have strategic importance for firms. In addition, as discussed in the provisional findings (see paragraph 9.190 and 9.191), the potential gains from winning or retaining an engagement may also include the likelihood that this would lead to other work with the client, and the strategic value to the firm of building, maintaining and demonstrating expertise in winning other audit engagements which could also generate additional non-audit work.

3.111 We also consider that there would be strategic risks for the leading firms to be very selective in the tender processes in which they decided to participate. Whilst the probability that a given company will switch may be lower, rival firms would not be in a strong position to determine which companies are the ones that are more likely to switch following the tender process. Given this uncertainty, such a strategy could be very risky for a firm. In particular, it could result in a failure to gain engagements for which it was well placed and give rival firms an opportunity to build reputation and experience.

◦ *Conflict issues may reduce numbers of firms bidding*

3.112 In the provisional findings we reported that the Big 4 firms had said that the issues of conflicts of interest and independence could generally be resolved if some time was allowed, and that it would be in the interests of companies to facilitate this if they considered it necessary for a competitive tender process.¹⁰² Further, the Big 4 firms said that it would not be in a firm's interest to decide not to compete for an audit engagement in order to retain non-audit work as this would be damaging to its relationship with the company (see the provisional findings, paragraph 9.22).

3.113 We consider that if a refusal to participate in a tender process in this context would be potentially damaging to the firm's relationship with its clients, we could expect this also to be the case were a firm to refuse on the basis that its chances of winning the engagement were insufficient to justify the costs involved in participating in the tender process.

3.114 KPMG said that increased tendering would impose additional administrative costs on audit firms since any time an audit firm participated in a tender process it had to identify the provision of NAS that could breach its independence as the auditor of the potential client. No firm participating in a bid would offer new prohibited NAS until it knew whether or not it had been successful in the audit tender process. KPMG said that, 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 might have to pass them on to FTSE 350 companies as part of their audit fees.¹⁰³

¹⁰² Deloitte response to the CC working paper 'Nature and strength of competition', paragraph 7.19.

¹⁰³ KPMG response to the Remedies Notice, paragraphs 3.2.8.1–3.2.8.8.

3.115 We consider that such matters would typically not need to be addressed in advance of a tender process. During a tender process it would generally be sufficient for the firm and company to identify such issues and to be confident that these could be resolved on appointment. We recognize that for companies subject to sector-specific independence rules (in particular, those in the banking sector), identifying and resolving conflicts could be more difficult. We would, however, expect firms to develop the systems necessary to manage such issues and identify issues quickly when required, and for companies to take such matters into account when awarding NAS contracts to avoid being a position where choice of auditor is overly restricted as a result.

◦ *Firms have insufficient resources to participate in all tender processes*

3.116 The Big 4 firms said that the availability of resources—mainly senior audit staff—would be a serious constraint on participation in tender processes were the CC to require companies to go out to tender every five years (paragraph 3.34). The firms argued that they would need to employ additional people and/or divert people who would otherwise be working on other engagements including audit engagements. KPMG argued that the latter could be detrimental to the quality of audits. The firms suggested that the availability of people with the required skills was limited.

3.117 We do not accept this. We consider that it would be a high-risk strategy, and therefore unlikely, for a firm to divert people away from audit engagements in order to participate in more tender processes if this were to lead to fall in quality. In addition, we are not persuaded that there would be such serious constraints on the availability of people required to participate in tender processes. In particular:

(a) As explained above (see paragraph 3.84), we consider that, with companies going out to tender every five years, a proportion of the additional partner time required to participate in these tender processes would be time that might

otherwise have been allocated to marketing activities. We consider that such activity would be less relevant if there were tendering processes every five years.

(b) Firms might also need to recruit additional resources to meet the demands of participating in more tender processes. We accept that this would come at a cost which is allowed for in the estimated opportunity cost to firms of participating in tender processes (see paragraph 3.79). We do not accept that recruiting additional people would not be an option. Firms would have time to respond to the new arrangements. They might increase the number of audit partners and directors. We recognize that these are highly skilled individuals and that in some sectors auditing requires some particular skills (eg actuaries for insurance clients). We do not, however, consider that the supply of these people is fixed except perhaps in the short term.

3.118 Nevertheless, as stated above, we accept, all other things being equal, that the incentives to participate in tender processes may be lower with tendering every five years. We would therefore expect firms to give careful thought to whether or not to accept invitations to tender. We might expect an extended pre-tender process in which firms discuss with the company their participation in the forthcoming tender process. It is possible that the firms that judge themselves to be in a weaker position in competing for a given engagement would be more likely to decline the invitation to tender. The result could therefore be fewer firms being invited to tender but the invitees being those best placed to compete for the engagement. Conversely, firms might be more selective in deciding for which engagements to bid, but those firms that do compete are likely to do so aggressively.

◦ *Firms expend less effort in when bidding*

3.119 We also considered the possibility that firms would continue to participate in tender processes when invited to do so but would expend less effort in producing a good

tender. Our provisional view is that it is highly unlikely that a firm would accept an invitation to tender but allocate to the bid process resources that would be considered insufficient to submit a bid that met its standards. We consider that this would be a costly and risky strategy for a firm. In particular, whilst such a strategy would avoid the potential damage to a client relationship that a refusal to participate in a tender process could cause, the firm would incur costs of participating in the tender, would have reduce chance of winning and a poor performance could be damaging to the firm's reputation (see the provisional findings paragraph 9.243).

3.120 However, as explained above, we do consider that firms would have incentives if tendering occurred every five years to look for, and invest in, ways to be more efficient in tender processes (see paragraphs 3.68 to 3.73).

- *Incentives for firms to invest in their capabilities*

3.121 A key factor in the negotiating position of a company is the availability of good outside options (see the provisional findings, paragraph 9.6). We observed in the provisional findings that whilst each of the Big 4 firms has a presence in the supply of FTSE 350 audit services in most sectors, there are many sectors where the performance of one or two of these firms has been consistently weak, measured by their shares of engagements and fees.¹⁰⁴ We found that Mid Tier firms had a limited presence in the FTSE 350¹⁰⁵ and that Mid Tier firms had been held back by their inability to point to significant experience of auditing equivalent companies.¹⁰⁶

3.122 In our assessment of barriers to entry and growth in the provisional findings we set out the difficulties firms face in trying to build expertise, experience and reputation in sectors where they are currently weak.

¹⁰⁴ Provisional findings, paragraph 9.13.

¹⁰⁵ Provisional findings, paragraph 9.12.

¹⁰⁶ Provisional findings, paragraph 10.31.

3.123 We consider that companies going out to tender every five years could encourage firms to invest more in the development of their capabilities. This would apply to both Big 4 and Mid Tier firms alike. It is our view that one of the main barriers to firms investing in the capabilities required to compete for certain audit engagements is the infrequency with which engagements are put out to tender. In addition, currently firms do not know when, or if, certain audit engagements may be opened up to competition and are sometimes given short notice that engagements have become available.

3.124 With companies going out to tender every five years firms will know (a) that there will be a competition for all FTSE 350 engagements every so many years and (b) given the date of the last tender process, when the next tender is likely to take place and by when it must take place. We consider that the increased opportunities to compete for engagements and the greater certainty on when these engagements will be open to competition, will improve firms' abilities to develop strategies in relation to the engagements for which they would like to be in a position to compete.

- *The incentives of companies in the conduct of tender processes*

3.125 In the provisional findings, we found that tender processes for FTSE 350 audit engagements were typically structured and thorough processes in which companies seek to provide bidders with the access and information they need to prepare informed proposals; and the selection committee with the information they need to make an informed decision.¹⁰⁷ It is also our understanding that the specification of tender processes has largely been determined by the company.¹⁰⁸

3.126 We have considered the risk that companies conducting a tender process because they were required to do so, and for no other reason, would design a process that would be less thorough than it might otherwise be, in particular if the company had

¹⁰⁷ Provisional findings, paragraph 9.221.

¹⁰⁸ See provisional findings, Appendix 23 ('The tender process').

no intention at the start of the process to switch auditor and did not therefore expect to use the information gained through the process to select its auditor. This might produce a situation where companies would pretend to go out to tender, and firms would pretend to bid.

- 3.127 In the case studies (paragraph 3.23 above) the respondents identified the main cost to a company of conducting a tender process to be the opportunity cost of the time given by those involved and said that much of the time commitment was that taken up meeting with the firms. The people involved would very often be senior management. We were told that it was these opportunities that gave the firms access to the information that they needed to submit informed bids and that gave the company's management the opportunity to test the capabilities of the teams. Such processes were important to lessening the incumbent's advantage in the tender process, given its knowledge of the business.
- 3.128 We have therefore considered two broad possibilities: (a) that a company might restrict the access provided to firms to company employees. Firms may see fewer individuals and/or have less time with those they do see; and (b) that a company might invite fewer firms to participate in the tender process as the costs involved in providing firms with access to the company's management and the selection process will increase with the number of participants bidding.
- 3.129 Based on the responses in the recent case studies (see paragraphs 3.95 and 3.96) we consider that there is a risk of overstating the opportunity cost to companies of conducting a tender process and therefore the risk that companies would have an incentive to put in place a less demanding and robust process.

3.130 Nevertheless we recognize that for some companies, conducting tender processes may be time-consuming and disruptive. We consider, as stated above, that this is more likely to be the case for more complex audits such as those for companies with extensive international presence, multiple business lines, or companies in certain sectors where audits are technically more difficult. In these circumstances, the firms may want more time with key individuals in the organization and ideally the company would want more opportunity to explore with bidders their capabilities and proposals.

3.131 We discussed above the incentives (see paragraph 3.68) that firms and companies may have to become more efficient in the tender process. We think that the incentives for companies to design a process that is as efficient as possible will be particularly strong where the costs of tendering may deter firms from participating.

3.132 We consider that it is also possible that companies would specify processes that are less thorough than have been seen in the past. However:

(a) ACs are now required under the UK Corporate Governance Code to report to shareholders on the approach taken to the appointment and reappointment of the external auditor. This requirement would be strengthened were Remedy 1 implemented in conjunction with Remedies 5 (strengthened accountability of auditor to AC) and 4 (shareholder engagement). The process put in place by the company would need to be sufficiently robust for these purposes;

(b) as tendering becomes more frequent we expect best practice to become established, so that it will become obvious if any given company departs from expected norms. In this regard, the FRC recently published advice to companies on conducting effective audit tender processes;¹⁰⁹ and

(c) the willingness of rival firms to participate in the tender would be a further constraint. Rival firms are likely to be less willing to participate in processes that

¹⁰⁹ FRC, *Audit Tenders: Notes on best practice*, July 2013.

would give them insufficient access to overcome the incumbency advantage. It would be damaging to a company if it were unable to run a tender because firms refused to participate in the process it proposed.

- *Effect on incumbents' incentives between tenders*

3.133 We consider that increased frequency of tendering could improve the bargaining position of companies between tenders. In particular, we found in the provisional findings that companies were likely to be best informed in the years immediately after a tender. In these years the approach taken to the engagement, the scope of the engagement and the fee would have recently been subject to detailed scrutiny (see paragraphs 9.256 and 9.258(c)).

3.134 We also consider that the information gained from the participation of the ACC or other members of the AC or board in tenders for other FTSE 350 audit engagements may assist in the annual renegotiations with the incumbent auditor. The tenders may, for example, provide information that would facilitate the performance benchmarking of the incumbent auditor.

3.135 Finally, we consider that the knowledge that the incumbent firm will face open competition for the engagement in at most five to seven years will increase considerably the bargaining position of the company. The firms have said that the threat of losing an engagement is a significant factor in the assessment of the relative bargaining position of the firm and the company. With tendering every five years there is a greater chance that any underperformance will become apparent to the company and result in the incumbent's replacement. Moreover, the requirement on the company to conduct a tender has the effect of overriding the barriers to a company testing the market.

3.136 In the provisional findings we found that firms may incur significant costs if they lose a client. They lose the income stream of the engagement; their portfolio of engagements in any given sector is weakened (although the extent to which this matters will depend on the strength of the retained portfolio); and they may suffer reputational damage, depending on the circumstances of the loss. We consider that this would remain the case with tendering every five years. Although it may be easier for a firm that loses an engagement to target and obtain a replacement engagement, it must still incur the costs in becoming expert regarding that company's business (see the provisional findings, paragraph 9.215). Accordingly, we consider that an incumbent's incentives are not significantly changed by increasing the frequency of tendering to once every five years.

3.137 KPMG said that, under a mandatory tendering remedy, with no 'comply or explain provision', any company which tenders for audit services outside of the prescribed window was more likely to be dissatisfied with its current audit provider, as it would be unlikely to be tendering simply for good governance reasons, for example. This meant that any tendering events outside of the predefined windows were more likely to send adverse signals to investors, imposing a cost to companies.¹¹⁰ We consider the implication of this argument to be that tendering every five years would undermine the bargaining power of the company between tenders.

3.138 We do not accept this argument. First, KPMG argued, in the context of considering its incentives to participate in tenders, that currently tenders often occurred as a result of dissatisfaction with the incumbent auditor.¹¹¹ This is consistent with evidence on the frequency with which the incumbent has retained an engagement following a tender. Second, KPMG has not previously suggested that companies may be

¹¹⁰ [KPMG response to the Remedies Notice](#), paragraph 3.2.5.3.

¹¹¹ *ibid*, paragraph 3.2.6.1.

reluctant to go to tender in response to dissatisfaction with the incumbent auditor on the grounds that this may send an adverse signal to investors. On the contrary, it has argued that companies would be ready to go to tender in these circumstances.¹¹² Third, there are reasons other than dissatisfaction with the incumbent auditor why a company may decide to tender earlier than required to do so.

Effectiveness of open-book tendering

3.139 We consider that companies should have the powers to request that incumbent firms give them access to specified parts of the audit file for disclosure to the rival bidders.

3.140 We found in the provisional findings that companies made considerable efforts to ensure that rival firms have access to the information needed to submit bids (and have strong incentives to do so). The need for this is clear, given the advantage the incumbent would otherwise enjoy as a result of its knowledge of the company. However, the processes that companies have followed to disseminate the information required can be time-consuming, as they involve substantial management time in bilateral meetings with rival firms.

3.141 We also found evidence that potential rivals for an engagement would seek to develop a relationship with the company through the provision of other services. We consider that, whilst this would provide the firm with some familiarity of the company, the incumbent auditor would continue to have an advantage. A rival firm could not expect to acquire a detailed knowledge of, for example, a company's financial control systems or accounting treatments in the provision of, say, tax advice.

3.142 We consider that the possibility for an AC to disclose specified parts of the audit file could be helpful the company to achieve efficiencies in the design of a tender

¹¹² [ibid](#), paragraph 3.7.2.2.

process by (a) providing a mechanism for the dissemination of information that reduces the amount of time that management spend in educating rival audit firms, and (b) reducing the incumbency advantage by facilitating the dissemination of information.

3.143 We agree that there would be risks if rival firms were to be provided with complete access to the audit file. There would be dangers that commercially confidential information might be disclosed and that information on the methodologies of the incumbent firms might become available to rival firms and undermine incentives to innovate. We also noted the arguments that it would be time-consuming for rival bidders to process the information provided by such an open-book approach.

3.144 We therefore consider that companies should have the power to request that the incumbent firm disclose only specified parts of the file which would provide rival firms with information specific to the audit and which would not compromise the commercial confidentiality of the company or firm or the intellectual property of the incumbent firm. We consider that companies would not have an incentive to undermine the investment incentives of its auditor, current or future, and would be best placed to judge whether disclosure of part of the access file would be beneficial to the tender process. We might expect the disclosure process to operate in much the same way as the data room used by Companies N and W in the case studies (see Appendix 1.1, paragraph 32).

3.145 The types of information for which the company may request disclosure have been set out in submissions to the CC. The information that firms have said would be valuable to rival firms include the following:¹¹³

¹¹³ EY response to the Remedies Notice, Annex 2, paragraphs 2.7a), 2.10 & 2.12.

- (a) the principal audit risks and an accompanying 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.

Our view of the appropriate frequency of mandatory tendering

3.146 Following consideration of the various relevant factors in the above sections that have a bearing on the appropriate frequency and form of tenders, this section seeks to summarize how these factors have led us to propose that companies should tender the audit at least once every five years, with the option for companies to delay the tender in exceptional circumstances for up to two years.

3.147 As noted in paragraph 1.7, the CC in determining remedies must have ‘regard to the need to achieve as comprehensive a solution as is reasonable and practicable’. The CC will generally look for remedies that prevent an AEC by extinguishing its cause and will favour remedies ‘that can be expected to show results within a relatively short time’.¹¹⁴

3.148 The FRC’s UK Corporate Governance Code states, since its revision in September 2012, that FTSE 350 companies should put the external audit contract out to tender at least every ten years. We note that the FRC determined the period of ten years in a different context to that of a competition investigation in which we have a duty to remedy the AEC that we have provisionally found. We therefore have to form our own conclusions on the appropriate tendering period, having regard to the views of the FRC as the relevant sectoral regulator.

¹¹⁴ CC3 (Revised), paragraph 337.

3.149 As outlined in previous sections we consider that tendering every five years is likely to generate the following significant benefits compared with tendering every ten years:

- (a) It would increase the bargaining power of FTSE 350 companies both during tenders and in between tenders (paragraph 3.13).
- (b) It would focus competition on a tender process in which the AC has an influential role in the specification of the process and the auditor selection and contribute to ensuring that shareholder interests are given appropriate weight (paragraph 3.15).
- (c) It is likely to stimulate increased choice both within the Big 4 and by Mid Tier firms for the provision of audit services (paragraphs 3.14 and 3.121 to 3.124).
- (d) It may reduce the perception of a familiarity threat and may lead to improvements in audit quality and innovation through deployment of new personnel and techniques (paragraph 3.16).
- (e) The benefits of more regular tendering may also combine with the effects of other proposed remedies to address the AEC, in particular those designed to strengthen further the influence of the AC in the external audit relationship, and encourage shareholder engagement.

3.150 In response to our Remedies Notice several respondents, particularly the Big 4 firms, expressed concerns over higher costs for companies and firms and reduced competitiveness of tenders in the event of more frequent tendering. Our views on these effects are summarized as follows:

- (a) Costs for companies. We considered that companies' costs would be largely restricted to the opportunity cost of management time in organizing and participating in the tender process. There might be some incremental costs incurred in engaging external procurement specialists. We would expect that companies would generally be able to accommodate tenders as part of finance

department activities and that the ability of companies to defer tendering by up to two years will avoid the need to tender at times when the opportunity costs of doing so are high. Further, we consider that with increased experience, companies will likely become more effective at operating tenders.

(b) Costs for firms. We estimated an upper bound for the costs of firms participating in the increased number of tenders resulting from the requirement for companies to go out to tender every five years at £23.6 million a year, assuming a tender cost of £225,000 per firm and three firms participating in each tender. However, we consider that the incremental costs will be significantly less than this as more frequent tendering is likely to divert resources currently spent on marketing activities outside of tender processes. Further, we consider that there is scope for firms and companies to reduce the costs of audit tenders as they become more familiar with the process and design them more efficiently.

(c) Effectiveness of tenders. It is likely that in some instances companies will design tender processes that are more selective and invite fewer firms to compete in them as a result of a more rigorous pre-selection process. We think that if this is the case, the firms selected will retain incentives to compete aggressively and hence we do not consider that there will be a reduction in the effectiveness of tenders by increasing the frequency of tenders to every five years.

3.151 Although the benefits of increased frequency of tendering, as noted above, are inevitably difficult to quantify as they rely on the interplay of dynamic competitive processes and involve intangible factors, such as degrees of influence, audit quality and scepticism, in our judgement we consider that these will significantly exceed the incremental costs of tendering every five years with the option of two years of deferral.

3.152 As an illustrative exercise, we have estimated the upper bound of incremental costs associated with this remedy, including to companies and to firms, at £30 million a year, although we expect actual incremental costs to be significantly lower than that, perhaps in the region of £10 million a year. To put this in context, the market capitalization of the FTSE 350 is over £2,113 billion¹¹⁵ and total annual audit fees for the FTSE 350 are in the order of £800 million.¹¹⁶

3.153 We note that in determining the tender period of ten years, the FRC had regard to the desirability of tenders coinciding with the end of a normal AEP engagement period in order to minimize disruption to companies (ie the tender period should comprise two AEP engagement periods of five years). Other respondents to our Remedies Notice also supported continuing the ten-year tendering period on the basis that this would coincide with the AEP rotation cycle. We support the desirability of the audit tender period coinciding with the end of an AEP rotation cycle as this would not only reduce disruption for companies but also reduce the incumbency advantage of the existing audit firm. This is a further important factor in supporting the decision to propose a tender period of five years which will coincide with an AEP rotation period.

3.154 Our provisional view is that mandatory tendering is an effective remedy and consider it to be a matter of judgement as to the appropriate interval between tenders. We note the FRC's judgement that five years was the appropriate interval for rotation of an AEP to ensure their scepticism and independence and see no grounds to alter it. We are persuaded of the benefits of aligning tender periods with AEP rotation, as this would limit the incumbent's advantage deriving from an in-post AEP to lead their bid team. We think ten years to be too long a time for an audit engagement not to be

¹¹⁵ Calculated based on LSE Main Market Factsheet May 2013, sum of top 327 companies by market capitalization.

¹¹⁶ See provisional findings, Appendix 5 ('Descriptive statistics'), Table 2.

subject to the high level of scrutiny and competition that takes place within a rigorous tender process.

- 3.155 In addition, and in line with the FRC's judgement that five years is the appropriate period for the safeguarding of auditor scepticism, we consider that a period of five years would best ensure the sustained alignment of auditor incentives with shareholder (rather than management) demand. We do not, however, consider from a competition analysis perspective that an intra-firm partner rotation adequately secures this position. While partner rotation plays a legitimate role in ensuring that individual audit partners are objective and independent, it does not disturb the economic incentives of the audit firm and it is those firm-level incentives that our analysis is primarily concerned with.
- 3.156 We also consider that firms have overstated the costs associated with tenders, and that with familiarity and experience those costs will reduce. The possibility for companies to delay tendering for one or two years would provide the flexibility they need to avoid tendering at times that would be particularly inconvenient. On balance we consider five years to be the appropriate interval.
- 3.157 Our provisional view is that the possibility for a company to delay a tender process should operate on a 'comply or explain' basis similar to that of the UK Corporate Governance Code. We note the statement in the UK Corporate Governance Code that where a company decides to 'explain' rather than 'comply' the reasons should be explained clearly and carefully to shareholders who may wish to discuss the position with the company. In addition, the company should set out the background, provide a clear rationale for the action it is taking and describe any mitigating action taken to

address any additional risks and maintain conformity with the relevant principle.¹¹⁷ It is our expectation that companies would delay a tender in exceptional circumstances where a tender in years 5 and/or 6 would not be in interests of shareholders. Whilst we do not wish to be prescriptive, we expect such circumstances to be largely limited to those identified by the audit firms (see paragraph 3.64).

- 3.158 We recognize that costs of tendering every five years would be greater for those companies with more complex audit requirements and those subject to stricter independence regulations. For these companies, we might expect both the cost to the company of conducting a tender to be higher and the costs to participating firms to be higher. We would, however, also expect the benefits to be had from tendering every five years to be higher for these companies. In particular:
- (a) the resources required to conduct these audits and the fees charged to these companies will also be larger and so therefore the potential gains from promoting more intense competition if this delivers fee reductions and efficiencies in the delivery of audit services to these companies;
 - (b) the companies with more complex audit requirements are likely to be among those with larger turnover and capitalization. The potential gains to shareholders from improvements in the trust shareholders can place in the audit are therefore likely to be greater for these companies; and
 - (c) banking audits are often cited as among the most complex. Following the financial crisis the Big 4 auditor firms were criticized for a failure to identify mounting risks.¹¹⁸ For this reason, we consider that the benefits to be had from a remedy that would contribute to restoring trust in audit reports and promoting effective corporate governance would be highly valued in this sector.

¹¹⁷ See FRC UKCGC as amended September 2012, p4, paragraph 3.

¹¹⁸ The House of Lords economic affairs committee accused the Big 4 audit firms of a 'dereliction of duty' in the run up to the financial crisis. See report of March 2011, abstract.

Implementation and enforcement

3.159 In deciding whether to take action itself by Order or make a recommendation for implementation by another body, the CC will consider the feasibility of implementation by Order and whether the other body will be willing and able to implement the recommendation on a timely basis.¹¹⁹ In general, the CC prefers to act by Order where appropriate, as an Order is binding and we can make it directly, so it is more likely to be effective in addressing the identified AEC. Further, the application of the principle of ‘comply or explain’ is not suited to every aspect of our proposed remedy here. In accordance with these considerations, we envisage that our requirement for FTSE 350 companies to put out to tender their external audit engagement every five years will be implemented by CC Order, rather than a recommendation to the FRC to amend the UK Corporate Governance Code.

3.160 The Order would require that FTSE 350 companies should put their statutory audit engagement out to tender at least once every five years, with the proviso that it may defer this obligation for two years if there are exceptional circumstances. For each of these two years, it must provide an explanation as to why it has not put the audit engagement out to tender in the Audit Committee Report.

3.161 By the end of year 7, the company *must* put its audit engagement out to tender.

3.162 It is our provisional view that the Order should prohibit auditors and FTSE 350 companies from entering into a statutory audit engagement agreement where the engagement has not been put out to tender in accordance with the provisions of the Order.

¹¹⁹ CC3 (Revised), paragraph 391.

- 3.163 The company may request that the incumbent audit firm provides access to certain elements of its audit file to bidders in the tender process. This is subject to such elements not containing commercially confidential information or infringing intellectual property rights.
- 3.164 We are not minded to mandate a particular form of tender process which companies must follow. This is because we are of the view that there are sufficient incentives on companies to conduct a thorough tender process (see paragraphs 3.125 to 3.132) and that companies are best placed to specify the form of the process to ensure that it is effective and efficient. We also note the FRC's recent notes on best practice in audit tenders.
- 3.165 We would require a compliance statement to be included as part of the Audit Committee Report to the effect that the company has complied with the provisions of the proposed Order.
- 3.166 We recommend that the FRC amends the UK Corporate Governance Code in line with the provisions of the proposed Order.
- 3.167 We have taken into account that the FTSE 350 is a 'shifting class' with companies periodically moving in or out of the listing. We are currently minded to provide that new entrants to the FTSE 350 listing are to be subject to the provisions of the proposed Order immediately upon entry into the listing. This would mean that calculation of the five-year period for the purposes of the proposed Order would take into account periods prior to entry into the FTSE 350. We are of the view that the proposed Order reflects good corporate governance which companies with aspirations to join the FTSE 350 are likely to follow, and in any event the requirements of the proposed Order can be taken into account and planned for by companies outside

the FTSE 350 listing. We would not therefore expect the provisions to be unduly onerous on companies outside of the FTSE 350 which subsequently enter the FTSE 350 listing.

Transitional provisions

- 3.168 The FRC recognized that its provision requiring tendering at least every ten years could be disruptive if a large number of companies were to go out to tender in the first year in which the revised UK Corporate Governance Code applied and issued guidance on transitional arrangements.¹²⁰ These arrangements are not binding.
- 3.169 The FRC said that companies should put the audit contract out to tender earlier than they would be expected to under these arrangements if they felt it was appropriate to do so, and shareholders should feel free to request them to do so. Equally, as with all other provisions of the UK Corporate Governance Code, companies could choose not to comply and explain why they had not done so. Whatever their decision, companies are encouraged to state when they first report against the 2012 UK Corporate Governance Code whether or not they anticipate putting the audit contract out to tender in due course.
- 3.170 The FRC suggested that the timing of tenders might be aligned with both the cycle for rotating the AEP and the length of time since the audit contract was previously put out to tender. The FRC suggested that where a company had put the audit contract out to tender or changed audit firm in or after 2000, the tender process might be deferred until the latter stages of the incoming AEP's term (in other words, for a further five years).

¹²⁰ www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx.

3.171 In determining the appropriate transition arrangements for implementing our proposals for mandatory tendering every five years, we agree with the FRC's principles that the timing of tenders should be aligned with the five-year cycle for rotating the AEP and should be influenced by the length of time since the audit contract was last put out to tender. However, we consider that exempting companies from tendering at the end of the current AEP five-year term if they have tendered in or after 2000 would permit an unduly long period of time to elapse between tenders for companies that tendered in the first half of the last decade. We therefore propose to limit exemption on this basis to those companies that have tendered on or after 2005.

3.172 Our provisional decision regarding transition to our required frequency of tendering is as follows:

- (a) FTSE 350 companies that last tendered the audit before 1 January 2005 (or have never done so), must go out to tender at the end of the current AEP rotation period;
- (b) FTSE 350 companies that have tendered since 1 January 2005 may choose not to hold a tender process at the end of the current AEP rotation period, but must do so by the final year of the following five year period; and
- (c) the above requirement will have mandatory effect, but a company may delay tendering by a period of up to two years in exceptional circumstances if it explains, in each year, the reasons for delay in the Audit Committee Report.

3.173 We estimate that the number of FTSE 350 companies that tendered between 2000 and 2005 to be less than 85.¹²¹ Under our proposed transitional arrangements these firms will now be required to tender at the end of the current AEP tenure, rather than being allowed to defer a tender for another five-year period under current FRC

¹²¹ The CC first survey results indicate that 23 per cent of current FTSE 350 companies had tendered in the last five years and a further 24 per cent in the last six to ten years (see Table 16).

guidelines. Consequently we estimate that our proposals will result in a relatively modest increase of around 15 to 17 firms per year tendering over the transitional period of five years as compared with a situation of compliance with the FRC's guidance.

3.174 We note that the Government has indicated that it will aim to have two common commencement dates each year for new legislation and regulations with a view to minimizing burdens on business. The dates are 6 April and 1 October and so far as possible we would aim to make use of these commencement dates.

3.175 On the basis that an Order will be made approximately six to nine months after the publication of the CC's final report, the statutory deadline for which is October 2013, we would expect it to have an application date of 1 October 2014.

3.176 The CC welcomes views on the proposed remedy and on the feasibility of the proposed timing and transitional provisions.

Assessment of Remedy 2: Audit Quality Review

We have provisionally decided to recommend to the FRC that:

- The controls, systems and processes of each of the 'major firms' identified by the FRC (those which have ten or more audit clients in the AQR team's scope) should be reviewed and reported with equal frequency.
- The AQR team should review every audit engagement in the FTSE 350 on average every five years, with each individual audit engagement in the FTSE 350 reviewed at least every seven years.

Introduction

3.177 In this subsection, we set out:

- (a) a summary of the proposal in our Remedies Notice;
- (b) the aim of the remedy;

- (c) views of parties;
- (d) our assessment of effectiveness; and
- (e) implementation considerations.

Remedies Notice proposal

3.178 In our Remedies Notice, we said that this remedy would ensure that FTSE 350 companies have better (ie more frequent, tailored, comparable, transparent) information on the quality of FTSE 350 audits provided by audit firms. This would facilitate comparability of companies' existing auditors with other options.

3.179 We considered that should the frequency of AQR team reporting be increased it would provide greater transparency of audit quality and more timely and reliable identification of emerging trends and issues. Further, if review of audit files were more frequent, companies would receive a more frequent company-specific review of their audit but would also benefit alongside shareholders from more publicly available results regarding the performance of all firms in the market.

Background and aim of the remedy

3.180 The FRC describes the AQR team's overall objective as to 'monitor and promote improvements in the quality of auditing of listed and other major public interest entities'.¹²²

3.181 The AQR team reports publically on its inspections of individual firms every one to three years, with the Big 4 firms reported on annually, BDO and GT biennially, and other firms less frequently. In 2013 there are nine firms which audit more than ten companies which fall in the scope of the AQR team. Firm-level inspection reports

¹²² www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx.

comment on firm-level systems, controls and processes. They give no visibility of engagement-specific findings.

3.182 To contribute towards the assessment of the effectiveness of a firm's systems and controls as part of the firm-level reviews, the AQR team performs a review of a sample of PIE audit engagements, concentrating on those posing highest systemic risk. The AQR team's findings on individual engagements are reported to the audit firm and company in question and are not publically available. The consolidated findings of audit file reviews are included in the firm-level inspection reports.

3.183 The FRC states that:

Our reviews of individual audits place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained. Our reviews of firm-wide procedures are wide-ranging in nature and include an assessment of how the culture within firms impacts on audit quality.¹²³

3.184 In the course of the our investigation we found that in the five years to March 2013 the AQR team on average reviewed FTSE 100 company audits between every six and seven years and FTSE 250 company audits every 11 years (excluding follow-up reviews).¹²⁴ However, because of the focus on priority sectors and systemically more risky companies, certain companies are reviewed more frequently than average, whilst companies considered to have less systemic risk such as investment trusts, are reviewed less frequently than average.

¹²³ [ibid.](#)

¹²⁴ Provisional findings, paragraph 9.122.

3.185 In our provisional findings, we found that AQR team was the only external source of information on individual audit engagements that had access to the audit files of PIEs.¹²⁵ We found that the use of AQR team reports on specific engagements varied, but it appeared that reports were considered carefully by ACCs.¹²⁶ A number of companies in our case studies had read AQR findings at both an engagement and firm level with one of the AEPs referring to having raised his auditor's firm level report with the AEP.¹²⁷

3.186 We found that firms generally saw AQR team reviews as providing a public measure of audit quality and could act as an incentive for audit firms to maintain and improve quality.¹²⁸

3.187 We consider that more frequent AQR would thus contribute towards remedying both aspects of the provisional AEC, ie companies' lack of bargaining power with regard to their incumbent auditor (our first theory of harm), and auditors' incentives to compete to satisfy executive management rather than shareholder demand (our second theory of harm).

Theory of Harm 1: Companies' bargaining power

3.188 In our provisional findings we found that a company's bargaining power was partially determined by its ability to appraise the offering received from its current auditor. Whilst we noted that companies could assess the level of service quality, we did not think that companies necessarily had full visibility of technical aspects of quality.¹²⁹ We believe that the visibility of different aspects of audit quality will vary by individual,

¹²⁵ Provisional findings, paragraph 7.101.

¹²⁶ Provisional findings, paragraph 9.123.

¹²⁷ Provisional findings, paragraph 9.125.

¹²⁸ Provisional findings, paragraph 9.126.

¹²⁹ Provisional findings, paragraphs 5.55 & 9.58–100.

for example according to level of involvement with the audit, or level of technical knowledge.¹³⁰

3.189 Notwithstanding this, companies will have greater insight into the quality of their own auditor than of the quality of other auditors.¹³¹ In our provisional findings we found that a company's bargaining power was determined in part by its ability to assess the offering of other suppliers. We found that companies had limited ability to judge the technical quality of other firms.¹³² The AQR team's firm-level reports have a role to play, but the relatively small number of FTSE 350 audit files reviewed means that accurate judgements on comparative firm quality are difficult to make.¹³³

3.190 We consider that giving companies more and better information with which to assess the quality of their own auditor and other audit firms will contribute towards companies being able to make a more informed assessment of whether the offering of their incumbent auditor is competitive.

3.191 At present the AQR team issues firm-level reports on nine firms.¹³⁴ As the frequency of reporting for the firms differs (between annual and triennial), there is a disparity in the frequency, and by extension, volume, of information on the quality of audits and the systems and controls to ensure audit quality for different firms. We provisionally found that reputation¹³⁵ was an important factor to companies in selecting an auditor and acted as a barrier to entry which is difficult for Mid Tier firms to overcome without being able to demonstrate relevant experience. As such we consider that additional

¹³⁰ For example, in our provisional findings, paragraph 9.89, we identified that AC members may have less visibility of the detailed work of the auditor compared with finance staff and executive management.

¹³¹ Our reporting remedy requires ACs to report on the outcome of company-specific AQR findings, which will provide more information to the market.

¹³² Provisional findings, paragraphs 9.101–9.147. In our provisional findings, paragraph 9.103, we found that two-thirds of companies conducted benchmarking at least every five years, and 90 per cent of companies made informal comparisons but that the most common form of benchmarking was on fees. 10 per cent of respondents stated that they considered audit techniques, approach and accounting treatments.

¹³³ The AQR states that results of file reviews disclosed in individual firm-level reports should not be used to compare the relative audit quality of firms.

¹³⁴ The number is determined by the number of PIE audits that each firm conducts (and the recent merger of BDO and PKF).

¹³⁵ That is, perceived ability; provisional findings, paragraph 10.21.

independent information about the quality of these firms' large listed company audit engagements may help them to demonstrate relevant experience to the market.¹³⁶

Theory of Harm 2: Auditors' representation of shareholders' interests

- 3.192 The AC's role is to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements¹³⁷ on the behalf of shareholders.
- 3.193 A greater frequency of individual audit file review will give ACs more insight into the technical quality of their statutory audit. In our provisional findings we identified examples of ACCs who considered themselves to have partial visibility of the quality of the audit, in cases being dependent on management flagging issues to them¹³⁸ and we said that this lack of visibility was particularly relevant to technical aspects of audit quality.¹³⁹
- 3.194 An independent assessment of the technical quality of the audit will give the AC a mechanism with which to judge quality independently from executive management. We consider that more frequent audit file reviews by the AQR team will assist the AC in assessing the effectiveness of the external audit and in making informed decisions on the appointment of auditors.
- 3.195 Additionally, a greater frequency of audit file review will increase the likelihood that in any given year an audit file will be reviewed, incentivizing auditors to focus on technical audit quality, which is the principal demand of shareholders.

¹³⁶ We noted that reputation is often based on experience and may to some extent be synonymous with it, because of the difficulty of gauging quality in another way (provisional findings, paragraph 10.21). We further identified institutional preferences for the largest auditors which might be as a result of the 'IBM effect'; provisional findings, paragraphs 10.21–10.30; 10.28.

¹³⁷ [FRC Guidance to Audit Committees, September 2012](#), paragraph 2.2.

¹³⁸ Provisional findings, paragraph 11.39.

¹³⁹ Provisional findings, paragraph 9.89.

Views of parties

3.196 The views of parties are summarized here and are quoted at greater length in Appendix 3.3.

Frequency of reviews of individual audits

3.197 Case study interviewees generally found AQR to be useful and the majority who commented on this area supported increased frequency of company-level reviews, though there were differences in views as to which companies might be reviewed more frequently.

3.198 Submissions by investors and investor groups were generally favourable to increased AQR frequency, though investors differed on the optimum frequency. Some investors thought a prioritization of certain entities was beneficial. In response to our questionnaire, five investors supported a general increase in frequency of AQR team review, with others identifying improvements in the nature of AQR to be more useful. One investor suggested that all FTSE 350 audits should be reviewed every three years and another felt the nature of the review should be changed before increasing frequency.

3.199 One interviewee did not believe that increasing the frequency of review would change auditor behaviour and another believed that the introduction of the AQR had led to a focus on quality.

3.200 Two banks saw the benefit of being more informed in choosing an auditor as a result of increasing the frequency of file review, but one of the two stated that it doubted it would cause or accelerate a decision to retender or reduce the barriers to switching. Two companies did not see the need to increase frequency. Another two companies

indicated broad support for improving the level of information available, but one reserved judgement on the relative costs and benefits.

3.201 In its response to the Remedies Notice, the FRC stated that it 'agree[s] that there is scope to consider more frequent AQR inspections' but stated this was in 'some cases of higher risk'. The FRC also noted the potential for more detailed reporting.¹⁴⁰

3.202 Firms submitted a range of views. Two Mid Tier firms supported greater frequency, but another noted the danger of individual companies being identifiable. Two Big 4 firms questioned if the benefit of increased frequency exceeded the cost whilst another thought an increase in frequency might need to be offset by a more streamlined process.

Frequency of firm-level reporting

3.203 One investor explicitly referred to the different frequency of individual firm-level reports and believed this might inappropriately indicate a hierarchy in the audit market.

3.204 One Mid Tier firm supported all firms being reported on with the same frequency and at the same time. Two companies referred to the different review cycles of firms and that the remedy should address this.

Scope and content

3.205 Two investors noted that AQR was the only independent assessment of audit quality available to them, and another investor said AQR was 'but one' source of information. Several investors and one Mid Tier firm felt a greater focus on audit judgements

¹⁴⁰ [FRC response to the Remedies Notice](#), 18 March 2013.

rather than documentation would make the AQR more useful. Two companies did not see the need to increase the scope of AQR reporting.

3.206 Deloitte noted that the AQR was not a balanced scorecard of audit quality as it did not consider the relative complexity of an engagement, and further that the findings were not representative of the market as a whole because AQR focused on certain sectors. One Mid Tier firm noted the benefit of the AQR concluding on relative audit quality for comparable audits. Another Mid Tier firm did not support an expansion of scope, and whilst supportive of separate publication of FTSE 350 quality results noted that for firms with a small number of clients undue weight might be placed on the outcome of a single audit. Two Big 4 firms stated the scope of AQR was for the FRC to decide.

Shareholder access to company-specific findings

3.207 Investors differed on whether they read the presently available AQR reports with some investors explicitly noting that they did not do so because they did not include company-specific information. Investors held mixed views on whether there should be company-specific reporting, with some stating they would not have time to review company-specific findings and others warning that there might be an undesirable signalling effect to the market if the review found poor audit quality and whether this meant the financial statements needed reissuing. Other investors believed that company reporting would be particularly useful where the audit had been challenged or controversial and others saw company-specific reporting as providing even greater incentive to audit quality. One investor thought that it would be useful, but that in identifying a suitable format for publication the findings might be 'watered down' and another investor was concerned that firms would more aggressively challenge the AQR, which might make the process more adversarial and less open.

3.208 One Mid Tier firm thought that public AQR reporting could be primarily on a company basis (rather than a firm basis); another supported AC reporting of AQR findings.

3.209 Some respondents identified the risk of firms becoming more adversarial in agreeing AQR findings.

Utility to shareholders

3.210 Six shareholders explicitly referred to public AQR reports as being useful in assessing a firm's quality and two investors stated it was the only independent source of audit quality. One response on behalf of a number of investors stated that they rarely used AQR reports because they lacked information on individual audits.¹⁴¹ Some investors saw scope for improving the content or scope of AQR. Four investors stated that improving content would increase utility and others perceived there to be too much focus on paperwork and not enough on scepticism and judgement.

Assessment of effectiveness

3.211 In our assessment we draw primarily upon the evidence provided by provisional findings, submissions made in response to the Remedies Notice, and other evidence received since the publication of the Remedies Notice.

3.212 The aspects of this remedy which we consider are as follows:

- (a) The frequency of review of company audit files.
- (b) The frequency of reporting on audit firms.
- (c) Scope and content, including:
 - (i) comparability of gradings; and
 - (ii) companies in scope of remedy.
- (d) Shareholder access to company-specific findings.

¹⁴¹ A trade group made similar comments.

(e) We consider the current funding mechanism for the AQR team.

Frequency of audit file review

3.213 In this subsection we:

- (a) consider the existing frequency of review;
- (b) explain the rationale for increasing frequency;
- (c) design the remedy;
- (d) identify the optimal frequency of audit file reviews;
- (e) consider the cost of increasing the frequency of audit file reviews;
- (f) identify any additional benefits; and
- (g) set out our view.

- *Existing frequency of review*

3.214 At present individual audit engagements are on average reviewed infrequently, albeit with certain more risky audits reviewed more frequently. As discussed above, AQR team reports on individual audit files are the only source of independent information on technical audit quality. In our provisional findings, we considered that the time the average FTSE 350 company would have to wait for its audit to be reviewed was around ten years.

3.215 Because of the way that the AQR team selects which audit files to review, there is no theoretical maximum length of time between two successive AQRs. Based on the number of FTSE 350 audit files reviewed each year, we can calculate the average frequency, but as the selection of files is based on a risk profile, some companies will necessarily not be reviewed.

- *Rationale for increasing frequency of file review*

3.216 We think that increasing the frequency of audit file review would be beneficial, as

- (a) we think that the information contained in AQR reports has an important role to play in increasing visibility of audit quality and thereby improving company bargaining power; and
- (b) more frequent audit file reviews would improve the robustness of firm-level reports because they would be based on a more representative sample of audit engagements. Companies would be better able to make inferences on the relative quality of different firms as a result.

3.217 Further, increasing frequency of review would increase the likelihood that all AEPs would have at least one of their audit engagements subjected to scrutiny. Given that AEP tenure is typically at most five years, under the current AQR average frequency of ten years, companies would only gain insight into the audit delivered by every other AEP on the engagement, on average.

3.218 Similarly the present frequency of audit file review means that for an AC member there is no certainty that during their tenure (up to nine years, assuming they joined the AC on appointment as a non-executive director, but typically considerably less than this¹⁴²) they would receive an AQR report on the audit file.

- *Designing the remedy*

3.219 We considered how best to increase frequency of audit file reviews, whilst preventing unintended consequences, such as making the timing of AQR team file reviews predictable for firms, or constraining the AQR team's primary duty to ensure audit quality.

3.220 We recognize that the FRC's primary duty is to ensure audit quality of PIEs across the economy in general, and that certain companies are of greater interest than

¹⁴² There is a presumption that non-executive directors cease to be independent after nine years and would not be appropriate individuals for appointment to the AC.

others because of issues such as systemic financial risk. We considered the need to ensure some flexibility for the AQR team to focus more effort on such companies, whilst ensuring that all companies in the FTSE 350 would benefit from the remedy. This is important to ensure that our remedy does not have a detrimental effect on the AQR's primary duty of promoting high-quality audits of PIEs, subject to it obtaining appropriate resources.

3.221 We found that investors were in general in favour of greater frequency but that the views of parties on the optimal frequency varied. While a number of respondents favoured no change, others suggested every three, five or seven years. For a number of respondents, the mere existence of AQR and the potential for reputational damage should the AQR have negative findings was sufficient incentive to audit firms to ensure high-quality audits across the FTSE 350.

3.222 Of those investors that expressed a definite view, the majority were in favour of increasing AQR frequency.¹⁴³ We note that some investors that were not in favour of increased frequency held that view because of the lack of visibility at a company-specific level. This suggests to us that if company-specific information were made available, there would be more universal support for an increase in frequency from investors.

- *Identifying the optimal frequency*

3.223 To ensure the remedy is most effective, we considered other relevant reporting, tendering and rotation cycles.

3.224 As part of our remedies package we propose that companies should put the audit out to tender every five years. Aligning the AQR cycle to the tender cycle would increase

¹⁴³ See Appendix 3.3, AQR views.

the likelihood that a company would receive an AQR report on its audit at least once between every tender cycle.¹⁴⁴ The five-year cycle we identified for tendering was in part based on consideration of the AEP rotation cycle. By undertaking an AQR on average every five years, AEPs will, on average, be reviewed once during their tenure on every FTSE 350 audit.

3.225 We consider that aligning the cycle of AQR reviews with the tendering cycle will provide ACs with timely and relevant information on the quality of the audit engagement for use in the tender process.

3.226 In order to allow the AQR the necessary flexibility to focus attention on more risky audit files, and to prevent undue predictability on the timing of a particular file review, we consider that a maximum period of seven years should be allowed between file reviews.

- *The cost of increasing the frequency of audit file reviews*

3.227 We considered the cost implications of increasing individual audit file reviews to every five years on average.

3.228 The FRC informed us that, based on the current AQR reporting arrangements, the marginal cost of undertaking an inspection of a PIE would be in the range of £15,000 to £40,000,¹⁴⁵ but was unable to provide an indicative figure for the average company in the FTSE 350.¹⁴⁶ Using the maximum and minimum cost of conducting a file review for 70 audits a year (ie 350 over five years) gives a range of £1 million to £2.8 million per year. As this would be broadly a doubling of work, we can assume that at

¹⁴⁴ Whilst this information would be received on average at least every five years, the results of the AQR could be received after a tender has occurred. However, even where that tender results in a switch, there will be a benefit to the AC, as it will identify areas for the AC to apply additional scrutiny.

¹⁴⁵ The FRC told us that were it to be required to increase the number of reviews undertaken these costs might change.

¹⁴⁶ FRC, 25 June 2013.

least half of these costs are incurred at present. The marginal cost of the remedy is therefore in the order of £0.5 million to £1.4 million per year.

3.229 Given the current emphasis on larger, more complex audits, even if the overall frequency of review is doubled, this may not give rise to a doubling of cost. It is therefore reasonable to assume the marginal cost of the remedy would be towards the lower end of the above range, and would be unlikely to exceed £1 million per year.¹⁴⁷

3.230 In addition, there will be some additional opportunity costs to firms of responding to AQR queries. As the primary focus of the review is on the file itself we do not believe that these costs will be significant.

- *Additional benefits*

3.231 We identified other possible additional benefits arising from the resultant likely improvement in information on audit quality, such as increased confidence in capital markets. However, we have not been able to quantify these benefits.

- *Our view*

3.232 We concluded that AQR reviews should be more frequent than is the case at present and that, on average, a FTSE 350 company's audit file should be reviewed every five years, with a maximum interval for an individual company's audit to be reviewed every seven years.

3.233 We reached this decision as we believe that AQR is a valuable tool to companies and shareholders in assessing the offering of an incumbent auditor. We chose a

¹⁴⁷ For example, assuming the 50 largest companies cost £40,000, the next 50 cost £30,000, the next 200 £20,000 and the final 50 £15,000, gives a marginal cost estimate of £825,000. Note that there are around 35 FTSE 350 audits where the UK element of the audit fee is £40,000 or less, indicating a file review would potentially be relatively simple.

period of five years because our remedies package proposes requiring companies to tender their audits every five years and therefore on average companies are likely to receive an AQR of their incumbent auditor between tenders. Further, the five-year period also aligns with the rotation requirement of AEPs, increasing the likelihood that every AEP will be subject to review at least once for every FTSE 350 audit engagement.

3.234 We recognize the need for the AQR team to have the necessary flexibility to target risky audit engagements more frequently, and to facilitate this we have introduced a maximum interval between the reviews of a company's audit of seven years. Overall our remedy approximately doubles the number of companies which receive an AQR each year and we estimate that this will increase the AQR team's costs by approximately one-third to half of its existing total budget. We discuss these costs in further detail below.

Frequency of reporting on audit firms

3.235 At present the frequency of AQR reporting at audit firm level varies between one and three years.¹⁴⁸ This in part is a function of the number of companies within the AQR team's scope that each firm audits.

3.236 We understood that the frequency of firm-level reports is currently a function of the underlying number of PIE audits that each firm undertakes. The audit file reviews undertaken by the AQR team inform the assessment of the effectiveness of the controls, processes, systems and methodology of the firms. However, we note that the AQR team can and does perform a stand-alone assessment of these firm-wide aspects, and we can see benefit to reporting on them on an annual basis for all firms.

¹⁴⁸ The four largest annually, BDO and GT biennially and the other firms triennially. Since 2012 the AQR has delegated responsibility for the review of firms with fewer than ten PIE clients in the AQR's scope to the relevant RSB.

3.237 In response to our consultation, we received no comments that were opposed on principle to having all firms under the AQR team's scope reported on annually. Some parties identified issues around the dangers of individual clients being identifiable if reporting was too granular within those firm-level reports. Two companies and one investor noted that having different frequencies of review suggested a hierarchy or inherent differences between the different firms. This view is consistent with our understanding of the importance of reputation in the audit market.

3.238 By reporting on a larger set of audit firms annually, we consider that the larger Mid Tier firms will be better able to demonstrate experience and capability in PIE audits and companies will have more timely information on the quality of these firms. We recognize that the extent to which Mid Tier firms are able to use such reports to demonstrate quality is dependent on the findings of the reviews, however, we think that this remedy at least affords the possibility of doing so, and as a result may increase choice. Further, the remedy would contribute to dispelling presumptions of differences in quality between firms on the basis they are not subject to the same regulatory regime.

- *Cost of increasing the frequency of firm reviews*

3.239 At present the AQR team currently reviews audit quality of around ten firms. The FRC informed us that the cost of inspecting a firm's quality control systems and reporting publicly on the results of that work was estimated at between £100,000 and £150,000.¹⁴⁹ We calculated that the marginal cost of annual firm reviews would be around £325,000 per year, as shown in Table 1.

¹⁴⁹ FRC response to CC data request, 25 June 2013.

TABLE 1 Marginal cost of all firms in the AQR's scope being reviewed annually

	<i>Big 4 firms</i>	<i>Next 2 firms</i>	<i>Next 3 firms</i>	<i>All firms in AQR scope</i>
<i>Existing arrangements</i>				
Number of firms inspected annually	4	1	1	6
Cost per review (£)	150,000	125,000	100,000	
Annual cost (£)	600,000	125,000	100,000	825,000
<i>Per the remedy</i>				
Number of firms inspected annually	4	2	3	9
Annual cost (£)	600,000	250,000	300,000	1,150,000
Marginal cost of remedy (£)	-	125,000	200,000	325,000

Source: CC analysis.

3.240 We believe that the principal cost will be the staff time required to perform the reviews as discussed above; however, it is likely that firms will incur some staff costs in preparing information for the AQR and responding to queries.

- *Our view*

3.241 We believe there is merit in the FRC reporting on major firms auditing PIE companies with equal frequency and at the same time. We believe that the current cycle of review, whilst being a pragmatic response to focusing resource on those firms which audit the largest number of PIEs, may have a negative impact on perceived abilities of different firms and on the ability of the larger Mid Tier firms to demonstrate experience and quality in the audit of larger listed companies. We conclude therefore that all firms under the scope of AQR should be subject to annual review.

Scope and content

- *Comparability of gradings*

3.242 We have considered whether there was merit in changing the scope of the work of the AQR team, including the contents of reports, to increase their utility for ACs and shareholders in assessing audit effectiveness and comparing quality between firms.

- 3.243 We note that by increasing the frequency of individual file reviews, the firm-level reports will be based on a more representative sample of audit files, and will therefore be more suitable for the purpose of comparing audit firm quality.
- 3.244 A small number of parties¹⁵⁰ noted that the utility of AQR was diminished by being process driven, focusing on how firms have documented compliance with ISAs rather than how they had reached decisions. We found this surprising given that the AQR team clearly states that its objectives are to focus on audit judgements, and the FRC confirmed that this was the case. We concluded that these comments reflected a misunderstanding of the current scope rather than indicating a need for change.
- 3.245 A number of parties, including several firms, stated that the FRC should be responsible for setting the scope of its reviews.
- 3.246 We note that the AQR team has started a pilot to include an interview of a company's ACC as part of its review process and we believe such interviews may have a beneficial effect on developing the scope of the review and adding context to its findings.
- 3.247 The evidence that we have seen suggests that companies and investors generally value the information from AQR file reviews and firm-level reports and were supportive of the work of the AQR team. We considered that the AQR team's emphasis on how judgements were reached and whether those judgements were appropriate was important and provided helpful information to investors and companies about such aspects of audit quality where visibility might otherwise be low.

¹⁵⁰ Appendix 3.3, paragraphs 1, 5, 8 & 32.

3.248 We have therefore proposed remedies to increase the frequency of AQR review but make no recommendations in relation to the scope and content of the reviews themselves.

- *Companies in scope*

3.249 The terms of reference of this investigation has defined large companies to be defined as the FTSE 350, which is a fluid group of companies. Framing the remedy on a changing group of companies means that the remedy needs to be designed so that companies that move in and out of the FTSE 350 are not reviewed with an inappropriate frequency. However, given that companies moving out of the FTSE 350 will still be subject to the scope of the AQR, we believe that this issue should be managed by the FRC in determining its programme of file reviews in pursuance of its objectives.

Shareholder access to company-specific findings

3.250 We received submissions on the potential for AQR reports on audit engagements to be made public and we investigated this further during case study interviews and our investor questionnaire. We discuss this further in Remedy 6 (see paragraph 3.457).

Funding the increase in the AQR's activities

3.251 We acknowledge that our remedies to increase the frequency of AQR will have a resource cost for the AQR team. We consider here how the AQR team is presently funded and how any increase in activity could be funded.

3.252 At present the costs of AQR are levied by the FRC on the Recognised Supervisory Bodies (RSBs) (the accounting institutes and principally the ICAEW) which recover the costs through fees levied on the firms. There are a number of possible options for funding the costs of the increased inspections that we propose:

- (a) An increased levy on institutes (current process).
- (b) A direct levy on the firm being reviewed.
- (c) Inclusion of AQR costs in the charges levied by the FRC on preparers of accounts (companies).
- (d) Direct government funding.

3.253 Under the present funding regime, the burden of this remedy would be directly incurred by firms. The costs of any change fall into two categories:

- (a) The additional net cost of the FRC's resourcing for AQR.
- (b) The additional net cost of hosting and responding to AQR queries.

3.254 We would expect firms to recover these costs from companies and thus shareholders through fees. However, this pass-through of costs may affect companies outside of the FTSE 350 if the fees paid to the relevant RSB are recovered through a general increase in rates charged to clients. A more equitable solution might be for the FRC to levy these costs on the FTSE 350 as an additional fee to preparers of accounts as this cost would be offset directly against the benefits received by shareholders of FTSE 350 companies.

3.255 We consider that the FRC is best placed to determine the appropriate mechanism by which to recover the additional costs associated with this remedy.

Implementation

3.256 This remedy would be implemented as a recommendation to the FRC to increase the number of FTSE 350 audit files that the AQR reviews each year, set the maximum duration between reviews, and align the frequency of firm-level reviews for all firms auditing FTSE 350 companies.

3.257 We acknowledge that the implementation of this remedy will rely on the ability of the AQR team to expand its resources to undertake additional and more frequent AQR reviews. In light of this, we recommend that the remedy be implemented by the FRC as soon as is reasonably practicable.

Assessment of Remedy 3: Auditor clauses in loan agreements

Summary

We have provisionally decided on the following remedies in relation to auditor clauses in loan agreements:

- an Order prohibiting provisions in loan agreements which restrict or have the effect of restricting a company's choice of auditor to certain categories or lists of statutory auditors:
 - by company, we mean any company whose annual accounts for a financial year must be audited in accordance with Part 16 of the Companies Act 2006;
 - by loan agreements we mean any arrangement between such a company and one or more providers of debt capital for the purposes of providing borrowing facilities to that company. This includes bi-lateral and syndicated agreements and public prospectuses in relation to bond issues;
 - the prohibition will apply to the relevant provision(s) but does not affect the validity of the rest of the loan agreement;
 - the prohibition will not apply to loan agreements currently in force;
 - companies must monitor and certify compliance with the Order in their Annual Report; and
- a recommendation to the Loan Market Association that it amend the auditor clause in its template leveraged loan documentation in line with the provisions of the proposed Order.

Introduction

3.258 In this section we set out:

- (a) a summary of the Remedies Notice;¹⁵¹
- (b) the status of EU proposals on this topic;
- (c) how the remedy addresses the AEC;
- (d) views of parties;
- (e) design issues;
- (f) assessment of effects; and
- (g) implementation.

¹⁵¹ Remedies Notice, 22 February 2013.

Remedies Notice

3.259 In the Remedies Notice we noted that in template leveraged loan documentation (eg that provided by the Loan Market Association (LMA)), ‘auditors’ are defined as including one of the Big 4 firms although other firms may be appointed with the agreement of the majority of the lenders. These ‘Big-4-only’ clauses, which are optional but are often adopted without amendment, effectively mandated the use of a Big 4 firm for the duration of the loan agreement. Prohibition of such clauses could, in combination with other remedies, contribute to addressing the AEC that we provisionally found.

Status of EU proposals

3.260 The EU is currently considering reforms to the audit market. Draft EU Regulations¹⁵² seek to prohibit any contractual clause entered into between a PIE¹⁵³ and a third party which restricts the choice of that PIE, by general meeting of members, to certain categories or lists of statutory auditors to carry out the statutory audit (Article 32(7)). Further, the PIE would be required to inform the ‘competent authorities’¹⁵⁴ of any attempt by a third party to impose such a contractual clause or to otherwise influence the decision of the general meeting of members on the selection of a statutory auditor.

3.261 The preamble to the draft Regulations provides that the right of the general meeting of members to choose the statutory auditor would be of no value if the audited entity were to enter into a contract with a third party providing for such a restriction of choice.¹⁵⁵

¹⁵² http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf.

¹⁵³ Which includes all listed companies trading on a regulated market of any Member State.

¹⁵⁴ Article 35 of the Draft EU Regulations provides that each Member State shall designate a competent authority responsible for carrying out obligations under the Regulation and for ensuring that the provisions of the Regulation are applied.

¹⁵⁵ Draft EU Regulations, preamble paragraph 25.

3.262 Article 32 of the draft Regulations¹⁵⁶ also provides that, usually, the AC should submit at least two choices for the audit engagement to the administrative or supervisory board and shall express a duly justified preference for one of them. In any recommendation, the AC should state that its recommendation was free from influence by a third party and that no contractual clause restricting the choice of auditor (as outlined in Article 32(7)—see above) had been imposed on it.

3.263 A proposed draft EU Directive applies a similar prohibition in relation to non-PIE audited entities (by amending Article 37 of the Audit Directive (2006/43/EC)). The explanatory memorandum to the draft Directive provides that the amended Article 37 prohibits clauses according to which a third party ‘suggests, recommends or requires’ that the audited entity appoint a specific statutory auditor or firm.¹⁵⁷

How the remedy addresses the AEC

3.264 We found that experience and reputation were barriers to selection of an auditor which amounted to a feature that prevents, restricts or distorts competition in the FTSE 350 statutory audit market. This feature could individually or in combination with other features mean that the choice companies have when considering switching is more limited than would be the case if more firms had the reputation and experience that the Big 4 firms enjoy.¹⁵⁸ We provisionally found that Mid Tier firms faced barriers to expansion and selection in the FTSE 350 statutory audit market due to their lack of experience and reputation.¹⁵⁹

3.265 We identified a tendency to prefer the Big 4 firms by private equity houses, institutional investors and investment banks.¹⁶⁰ This commonly held ‘City’ view is

¹⁵⁶ http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf.

¹⁵⁷ EU draft directive, paragraph 4.3, subparagraph 9.

¹⁵⁸ Provisional findings, paragraph 10.33.

¹⁵⁹ Provisional findings, paragraph 10.31.

¹⁶⁰ Provisional findings, paragraph 10.26; Appendix 7.

likely to be a factor companies preparing to list on the main market, or which are already listed, take into account in their decisions about auditor appointment. It implies that Mid Tier firms face difficulties in retaining audit clients who are planning to raise private equity or list on the main market. Given a preference for Big 4 firms by many institutions, it appears rational for a company to appoint a Big 4 firm. Further, the tendency to prefer a Big 4 auditor indicates some risk for a listed company in switching from a Big 4 firm to a Mid Tier firm.¹⁶¹

3.266 We also found that 'Big 4 only' clauses in some syndicated leveraged loan agreements effectively mandated the use of a Big 4 firm.¹⁶² The LMA's template leveraged loan documentation provides that: 'Auditor means one of [Pricewaterhouse Coopers, Ernst and Young, KPMG, Deloitte and Touche] or any other firm approved in advance by the Majority Lenders (such approval not to be unreasonably withheld or delayed).'

3.267 The square brackets in the clause are significant because the LMA states its documents are designed to promote efficiency by creating a starting point for documentation based on market practice¹⁶³ and is subject to negotiation.¹⁶⁴ However, although there were examples of non-Big-4 firms being added to the clause, the clause was often left un-amended.¹⁶⁵ Thus, in practice the clause appears to be used mechanically. We note that the clause refers to 'Deloitte and Touche' (no longer the correct name of a Big 4 firm) which suggests that the clause is not reviewed regularly and is not based on any current appraisal of the quality of firms.

¹⁶¹ Provisional findings, paragraph 10.27.

¹⁶² Provisional findings, paragraph 10.26.

¹⁶³ Provisional findings, Appendix 7, paragraphs 19 and 21.

¹⁶⁴ [LMA remedies response](#), 9 May 2013.

¹⁶⁵ Provisional findings, Appendix 7, paragraph 21, CBS report.

3.268 In a syndicated loan requiring 'Majority Lender' approval of the appointment of an auditor other than one of the Big 4 firms (see paragraph 3.266 above), consent of lenders whose aggregate commitments are over 66 per cent of the total loan commitment would typically be needed to approve use of another audit firm.¹⁶⁶ We were told that in a large multinational and multi-party transaction, such approval might be hard to achieve and the company might consider it too onerous to pursue it. This suggests that in practice such clauses operate to require appointment of a Big 4 firm. We also found that the practice for bilateral loans appeared to be similar to that for syndicated loans and it was likely that Big-4-only clauses may appear in non-investment-grade bilateral agreements.¹⁶⁷

3.269 The main reasons for the template Big 4 only clause centre around the expectation of lenders and borrowers that the LMA documentation would be used, the familiarity of the Big 4 among international lenders and the importance to them of obtaining a high quality audit of financial covenants in highly leveraged transactions.¹⁶⁸

3.270 We found that it was difficult to define precisely which companies would be affected by the LMA's leveraged loan documentation but this could be a non-trivial proportion (at least 17) of the FTSE 350.¹⁶⁹ Most FTSE 350 companies would, however, be considered investment grade and we found that the LMA investment grade template did not contain such a clause.

3.271 BDO, in response to the Cardiff Business School (CBS) Report,¹⁷⁰ said that the effect of Big-4-only clauses was on companies outside the FTSE 350, whose debt was not then investment grade. BDO said that:

¹⁶⁶ Provisional findings, Appendix 7, Annex 1, paragraph 5.

¹⁶⁷ Provisional findings, Appendix 7, CBS report, paragraph 45.

¹⁶⁸ Provisional findings, Appendix 7, paragraph 3.

¹⁶⁹ Provisional findings, Appendix 7, paragraph 4.

¹⁷⁰ www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cbs_clauses_in_auditor_loan_agreements_bdo.pdf.

A change or choice of auditor away from a mid-tier firm to a Big Four firm is imposed on a growing company before it joins the FTSE 350, once it is in the FTSE 350, the company is highly unlikely to reverse that change. Therefore the effect of such requirements is to cut off custom for mid-tier firms and act as a barrier to them auditing present and prospective members of the FTSE 350. The high market share of the Big Four in the FTSE 350 therefore seems partly responsible for the absence of these clauses within the FTSE 350: those clauses apply most effectively outside the FTSE 350, particularly for companies with the potential to join the FTSE 350.

3.272 KPMG also stated that such clauses were not an issue for investment grade loans, which predominated in the FTSE 350, but documentation for leveraged loans could provide the impression of narrowing the choice of audit firms.¹⁷¹

3.273 It has been argued that such clauses are anti-competitive since they may restrict companies' ability to choose non-Big-4 firms and may have led to a perception that some lenders will only consider lending to companies which have their financial statements audited by one of the Big 4 firms.¹⁷²

3.274 We considered that such clauses added to the reputational barriers Mid Tier firms faced in expanding or entering the FTSE 350 statutory audit market.¹⁷³ In the Remedies Notice we said that prohibition of such clauses would address the AEC by:¹⁷⁴ (a) increasing companies' willingness to switch by providing particular companies with an increased pool of possible auditors; (b) reducing barriers to entry and expansion by reducing restrictions on non-Big-4 firms being retained or selected

¹⁷¹ Provisional findings, Appendix 7, paragraph 4.

¹⁷² Provisional findings, Appendix 7, CBS report paragraph 5.

¹⁷³ Provisional findings, paragraph 10.26.

¹⁷⁴ Remedies Notice, 22 February 2013.

as auditors; (c) reducing the role of reputation as a barrier to entry and selection for non-Big-4 firms; and (d) enhancing the effectiveness of other remedies designed to facilitate switching (for example, by removing restrictions on auditor choice, it may remove obstacles to mandatory use of tendering processes and mandatory switching).

Views of parties

- 3.275 In responding to our Remedies Notice, the LMA¹⁷⁵ disputed that its template auditor clause limited choice. It said that the clause is not compulsory—the names of the Big 4 firms are in square brackets indicating that it may be altered and the clause provides that any other firm may be appointed with Majority Lender approval.
- 3.276 The LMA pointed out that template documentation is designed to promote efficiency by creating a starting point based on market practice. Its template auditor clause also specifies 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.¹⁷⁶ 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.¹⁷⁷
- 3.277 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 does not specifically refer to the Big 4 firms by name, but otherwise remains the same. This would enable lenders to specify acceptable names

¹⁷⁵ [LMA remedies response](#), 9 May 2013.

¹⁷⁶ *ibid.*

¹⁷⁷ *ibid.*

when adopting the template documentation without additional complexity and delay by the parties having to agree the auditor in a separate process.¹⁷⁸ Finally, the LMA urged that careful consideration be given to any form of prohibition so as to avoid market uncertainty and potential disruption.

3.278 The British Bankers Association (BBA) stated that its member banks do not as a matter of policy stipulate a Big 4 firm. The LMA documentation indicates that lenders and investors should in the first instance consider whether an auditor with a global reach is needed. This, however, is not mandated even in this limited circumstance.

3.279 Barclays Bank Plc stated that it did not have a 'systematic policy' as a condition of providing financing that borrowers used 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 were appropriate in the particular circumstances.¹⁷⁹

3.280 RBS said that it did not insist on such clauses and did not object in principle to this remedy.¹⁸⁰

3.281 Other respondents to our Remedies Notice were almost universally in favour of a prohibition on Big-4-only clauses, in some form.

3.282 Among responses from investors, those from BlackRock, Hermes Equity Ownership Service, Legal and General Investment Management, the UK Shareholders'

¹⁷⁸ *ibid.*

¹⁷⁹ [Barclays remedies response](#), 18 March 2013.

¹⁸⁰ [RBS remedies response](#), 18 March 2013.

Association, and a coalition of eight institutional investors¹⁸¹ supported the proposed prohibition.

3.283 Respondents to our investor questionnaire were broadly in favour of the proposed remedy, although one investor did not believe it would be a good idea.

3.284 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.

3.285 The FRC supported a ban on such clauses in loan and 'other banking agreements'.¹⁸² 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 was a considered decision as opposed to a default position contained in advisers' standard documentation.¹⁸³

3.286 The Chartered Financial Analyst Society of the UK supported the prohibition in all documentation. The main benefit would be to open up tender processes to more firms and would not add to costs.

3.287 Audit firms, including the Big 4 firms, broadly supported the proposed measure.

3.288 Greater details of the views of parties on Big-4-only clauses in loan agreements are set out in Appendix 3.4.

¹⁸¹ USS; RPMI Railpen; NEST; LAPFF; LPFA; Governance for Owners; Environment Agency Active Pension Fund; Sarasin & Partners LLP.

¹⁸² [FRC remedies response](#), 18 March 2013.

¹⁸³ FRC follow up response, 25 June 2013, Q11.

Design issues

3.289 As noted in Appendix 3.4, there was support from some respondents to the Remedies Notice for the prohibition being applied more widely than the LMA template leveraged loan documents, for example, banks' own templates, and non-lending agreements. There was also concern that prohibiting such clauses may not remedy verbal arrangements or informal pressure which has the same effect as a Big-4-only clause. Some respondents noted that there might be occasions when a lender or lenders, for legitimate commercial reasons, required that a particular auditor be appointed.

3.290 We identified a tendency to prefer the Big 4 firms by private equity houses, institutional investors and investment banks, and concluded that this preference is likely to be a factor that companies take into account when appointing auditors. We also identified Big-4-only clauses in leveraged loan documentation as adding to barriers to selection for Mid Tier firms (see paragraphs 3.265 to 3.266 above). We note that leveraged loans are more likely to be prevalent among non-FTSE-350 companies (whilst affecting approximately 17 companies in the FTSE 350) (see paragraphs 3.270 to 3.272 above). Notwithstanding the relatively small number of FTSE 350 companies party to leveraged loan agreements, we think that the impact of the use of Big-4-only clauses (whether occurring in loan agreements within or outside of the FTSE 350 market) is felt within the reference market more widely for two reasons. Firstly, these clauses reinforce perceptions of differences in quality which affect auditor choice for FTSE 350 companies; secondly, the FTSE 350 is a fluid group and many of its current members are likely to have been exposed to leveraged loan documentation in the past before entering the index. These agreements may therefore have been a contributory factor in the high proportion of FTSE 350 companies using Big 4 audit firms.

- 3.291 We found some evidence of pressure to use Big 4 auditors when planning a public debt issue. We infer from this that public bond prospectuses may contain Big-4-only clauses, although we accept that we have not thoroughly investigated this matter, and would welcome further relevant submissions on this point. However, we aim to ‘deal comprehensively with the cause or causes of AECs wherever possible’.¹⁸⁴
- 3.292 In light of the findings discussed in paragraph 3.290, our provisional view is that we should issue an Order to the effect that provisions in loan agreements which restrict or have the effect of restricting a company’s choice of auditor to certain categories or lists of statutory auditors be prohibited. For these purposes, ‘company’ refers to any company whose annual accounts for a financial year must be audited in accordance with Part 16 of the Companies Act 2006. In view of the likely impact of the use of Big-4-only clauses in reinforcing barriers to selection, and our duty to have regard to the need to achieve as comprehensive a solution to the AEC and resulting customer detriment, as is reasonable and practicable, we do not feel this to be disproportionate.¹⁸⁵
- 3.293 By loan agreements we mean any arrangement between such a company and one or more providers of debt capital for the purposes of providing borrowing facilities to that company. In our provisional view this should include not only bilateral and syndicated agreements but also public prospectuses setting out terms for bond issues.
- 3.294 We intend for the prohibition to apply to relevant provisions rather than affecting the validity of the entire loan agreement. We consider this is a reasonable and proportionate way forward, avoiding unnecessary disruption in the market.

¹⁸⁴ CC3 (Revised), paragraph 330; the Act, section 138.

¹⁸⁵ *ibid.*

- 3.295 We do not propose that the prohibition should apply to loan agreements already in existence on the date on which the Order comes into force, again to avoid unnecessary disruption in the market. We provisionally propose that the Order applies to loan agreements entered into on or after the date on which the Order comes into force (see paragraph 3.310).
- 3.296 We have taken into account views that a lender may have legitimate commercial reasons as to appointment of a particular auditor. We have not proposed prohibiting companies and a lender (or lenders) entering into negotiations to appoint a specific auditor, for example due to an auditor's expertise in a relevant sector.
- 3.297 We consider that monitoring and enforcement of such Orders presents challenges and that relying on private enforcement by parties who may have suffered loss or damage due to a breach of the Order is unlikely to be an effective means of securing compliance with the Order. In view of this, we intend to include a reporting requirement in the Order. We would require a compliance statement to be included as part of a company's Annual Report to the effect that no loan agreement has been entered which is contrary to the prohibition. (In this regard, we note that the FRC's Guidance on ACs¹⁸⁶ already provides that the Audit Committee Report should include details of any contractual obligations that acted to restrict the AC's choice of external auditors.)
- 3.298 In relation to the LMA template leveraged loan documentation, we consider that it would be incongruous for the template documentation to be inconsistent with the proposed Order. We therefore provisionally intend to recommend to the LMA that it amend its auditor clause accordingly.

¹⁸⁶ September 2012, paragraph 4.26.

Assessment of effects

Effect on bargaining power

3.299 The proposed remedy would contribute to addressing the AEC found under our first theory of harm¹⁸⁷ by:

- (a) reducing barriers to entry and expansion by removing restrictions on choice; and
- (b) reducing reputational barriers faced by non-Big-4 firms and reinforced by Big-4-only clauses. Respondents have commented that such a remedy would send a strong message that such clauses are not acceptable and would have a significant symbolic effect within the reference market.¹⁸⁸

3.300 The remedy would therefore enable companies to make a more independent choice of auditor with less external pressure. It may also incentivize Mid Tier firms to compete more vigorously by reducing barriers to entry and selection.

Effect on costs

3.301 We sought parties' views as to the effect on costs:

- (a) BDO thought that such a remedy should be part of a package of remedies as such clauses were part of a wider problem in terms of barriers to entry and selection. BDO envisaged implementation through an Order. BDO thought that implementation costs would be low and outweighed by the benefits such as reducing barriers to entry and selection, thereby increasing competition, enabling companies to make independent choices and removing an obstacle to implementation of remedies such as mandatory rotation and/or mandatory use of tendering processes. The benefits would also include a clear public message that the authorities do not regard it as legitimate or necessary to restrict a company's choice of auditor to Big 4 firms. This may help persuade more companies to

¹⁸⁷ Provisional findings, paragraphs 13.3–13.5.

¹⁸⁸ For example, [PwC remedies response hearing summary](#), paragraph 76: prohibition would 'send a strong message to the market that those clauses are not acceptable.' [BDO hearing 10 April 2013, summary](#), paragraph 34: prohibition would 'send the right message'. [BDO remedies response](#), paragraph 4.4.2.

consider using Mid Tier firms and in turn help those firms offer companies more choice, innovation, lower prices and better services. Further, since the cumulative impact of the clauses reinforces the reputational advantage of Big 4 firms, prohibiting them will end that reinforcement and thereby help reduce barriers to entry, selection and expansion.¹⁸⁹

- (b) Deloitte believed that the costs were likely to be limited—principally procedural or administrative costs in the context of the LMA.¹⁹⁰
- (c) GT envisaged a legally binding prohibition with proportionate sanctions on the third party because it thought that non-binding guidance or recommendations will not be sufficient to end the use of such clauses. This should be supported by a requirement in the UK Corporate Governance Code to disclose any restrictions on choice of auditor. GT envisaged that there will not be any material cost to any parties arising from implementation.¹⁹¹
- (d) Kingston Smith believed the costs should be minimal and the benefits self evident, ie removal of an artificial restriction on choice.¹⁹²
- (e) The LMA believed, however, that having to engage in a process of agreeing an acceptable auditor each time introduces complexity and costs into the lending process.¹⁹³
- (f) PwC did not think that this remedy would be onerous to implement and envisaged a recommendation to the LMA to amend their precedents.¹⁹⁴

3.302 In our view, the remedy is not likely to have any significant cost implications for companies or firms since such clauses are unlikely to have been instigated by the borrower or the audit firm.¹⁹⁵ We note that any reporting requirement may impose

¹⁸⁹ [BDO remedies response](#), paragraph 4.4.2.

¹⁹⁰ [Deloitte remedies response](#), 18 March 2013.

¹⁹¹ [GT remedies response](#), 18 March 2013, Appendix paragraphs 3.9 & 3.11.

¹⁹² [Kingston Smith remedies response](#), 1 March, section 4.

¹⁹³ [LMA remedies response](#), 9 May 2013.

¹⁹⁴ [PwC remedies response](#), paragraph 3.49.

¹⁹⁵ In the context of the LMA leveraged loan documentation, CBS found that it is the banks which rely heavily on the LMA documents, rather than use being instigated by borrowers or firms. (Provisional findings Appendix 7, CBS report paragraph 35.)

some costs on companies. The FRC's Guidance on ACs requires that contractual obligations restricting the AC's choice of auditor be noted in the Audit Committee Report and we do not therefore see a material increment in costs as a result of any reporting requirement for companies that are subject to the UK Corporate Governance Code.

3.303 Lenders take into account multiple factors in their decision to lend. The impact of the proposed prohibition on any decision to lend is difficult to isolate.¹⁹⁶ We note the LMA suggest that its auditor clause is based on market practice, whilst there is an expectation of lenders and borrowers that the LMA documentation will be used (see paragraphs 3.267 and 3.269 above). This degree of circularity also suggests to us that the removal of such clauses is unlikely to impact on lenders' decision to lend. We are not therefore on balance convinced that the remedy will affect lenders' willingness to lend to any material degree.

3.304 We do not expect the proposed remedy to impose significant incremental costs on lenders. We would expect that in the majority of cases, a company's choice of auditor would not present concerns for lenders and individual negotiations would be required in isolated instances only.

3.305 In relation to changes to the LMA template documentation, we believe the costs on the LMA to be minimal and administrative in nature. We do not expect incremental costs on borrowers or lenders as a result of any changes to the template documentation.

¹⁹⁶ This is echoed by Deloitte remedies response hearing, p62, lines 5 & 6.

Effect on other proposed remedies

- 3.306 Such a remedy may facilitate the operation of mandatory use of tendering processes by providing a greater choice of auditors to companies.

Implementation

- 3.307 We intend to make an Order prohibiting provisions in loan agreements which restrict, or have the effect of restricting, a company's choice of auditor to certain categories or lists of statutory auditors.
- 3.308 An Order is not only binding on relevant market participants but is also likely to send a signal to the market. It is thus likely to be effective over time in mitigating perceptions that Mid Tier firms cannot compete in the market.
- 3.309 We note that the Government has indicated that it will aim to have two common commencement dates each year for new legislation and regulations with a view to minimizing burdens on business. The dates are 6 April and 1 October and as far as possible we would aim to make use of these dates.
- 3.310 Taking into account these dates, and the need to allow time for consultation on the Order following the publication of our final report by the statutory deadline of 20 October 2013, we propose that the Order would have an application date of 1 October 2014.
- 3.311 We also intend to make a recommendation to the LMA to amend the auditor clause in its template leverage loan documentation in line with the requirements of the proposed Order.

3.312 The CC welcomes views on the proposed remedy and the feasibility of the proposed timing.

Assessment of Remedy 4: Enhanced shareholder engagement

Summary

We have provisionally decided to recommend that:

- The FRC amend the UK Corporate Governance Code by introducing a specific obligation on companies with a Premium Listing:¹⁹⁷ (i) to engage with shareholders through seeking shareholder views on audit issues and stating how any shareholder concerns identified as a result may have been addressed; and (ii) to introduce an advisory vote for shareholders on the sufficiency of disclosure in the Audit Committee Report.
- The FRC update the Stewardship Code to encourage institutional investors to engage with investee companies on audit issues, through monitoring investee companies and escalating stewardship activities.

Introduction

3.313 In our provisional findings,¹⁹⁸ we found that competition is distorted to the extent that audit firms compete to satisfy the demands of executive management rather than those of shareholders. By encouraging shareholder engagement on audit issues this remedy is intended to ensure that shareholder demands are better met.¹⁹⁹ This may increase shareholder influence on the auditor appointment decision, and so give auditors increased incentives to focus their competitive efforts to satisfying shareholder demand. We consider that information provision is important to facilitate shareholder engagement, and our remedies in this area need to be considered alongside measures to improve information provision to shareholders, as discussed under Remedy 6 (paragraphs 3.427 and 3.478).

3.314 In this section we set out:

¹⁹⁷ All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report on how they have applied the UK Corporate Governance Code in their annual report and accounts. The relevant section of the Listing Rules can be found at: <http://fsahandbook.info/FSA/html/handbook/LR/9/8>.

¹⁹⁸ Provisional findings, 26 February 2013.

¹⁹⁹ See paragraph 7.204 and Section 11 of our provisional findings.

- (a) relevant background from the Remedies Notice;
- (b) a summary of recent relevant developments in the regulatory environment;
- (c) how this remedy addresses the AEC;
- (d) views of the parties;
- (e) effectiveness;
- (f) design issues;
- (g) interaction with other remedies;
- (h) assessment of effects; and
- (i) implementation of the remedy.

Remedies Notice and further options

3.315 In our Remedies Notice, we suggested four possible remedy design options to improve shareholder-auditor engagement:

- (a) change shareholder voting requirements to include an option to vote for holding a tender process for external audit appointment (the 'Tender Voting Remedy');
- (b) enhance the level of shareholder support required to reappoint the auditor (ie more than a simple majority) if a company proposed to reappoint its incumbent auditor after a mandatory tender process (the 'Enhanced Voting Remedy');
- (c) require the audit engagement partner (the 'AEP') to present directly to shareholders at AGMs (or other open shareholder forums) on the conduct and outcome of the audit (the 'AEP Presentation Remedy'); and/or
- (d) require the ACC to have a dedicated Question and Answer agenda item at AGMs (or other open shareholder forums) in which he or she answers questions directly on audit or financial reporting (the 'ACC Q&A Remedy').

3.316 Following responses to the Remedies Notice from interested stakeholders, we also considered three further options:

- (a) Companies should offer shareholders the choice of two possible auditors for appointment subsequent to a tender process.
- (b) We should recommend amendments to the UK Corporate Governance Code and Stewardship Code to encourage engagement on audit issues by both companies and shareholders.
- (c) We should recommend that shareholders in premium listed²⁰⁰ companies have an advisory vote on the sufficiency of the level of detail in the Audit Committee Report.

How this remedy addresses the AEC

3.317 In our Remedies Notice, we stated that the proposed remedy would address the AEC by:²⁰¹

- (a) providing shareholders with enhanced opportunities to influence auditor reappointment decisions through voting at AGMs;
- (b) providing shareholders with more information on the audit process and judgements so that they are better able to assess audit quality and, therefore, better able to vote on auditor reappointment decisions; and
- (c) as a consequential effect of increasing the influence of shareholders, we considered this would decrease the influence of management in the auditor selection decision.

Views of parties

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

²⁰⁰ The relevant section of the Listing Rules can be found at: <http://fsahandbook.info/FSA/html/handbook/LR/9/8>.

²⁰¹ See paragraph 55 of our Remedies Notice.

Investors

3.319 Most respondents to the investor questionnaire were supportive of the general principle of increasing shareholder-auditor engagement. However, the vast majority either opposed the Tender Voting Remedy and Enhanced Voting Remedy or had no view on the remedies' likely effectiveness. There was also a degree of scepticism as to whether the AEP Presentation Remedy and ACC Q&A Remedy would be effective.

Companies

3.320 CFOs and ACCs participating in the recent case studies were also asked for their views on the remedy. A frequently held view was that the level of shareholder interest in the audit was slight unless there was a particular problem.

Regulators

3.321 The FRC welcomed the principle of enhanced shareholder-auditor engagement. However, it pointed out that similar proposals had in the past received a largely negative response from investors and other market participants, and that significant time commitment from investors could not be relied upon.

Audit firms

3.322 Deloitte was broadly supportive of initiatives to increase shareholder-auditor engagement but opposed enhanced voting and saw difficulties in implementing the AEP presentation remedy. KPMG considered that increased reporting should not require the audit firm to offer subjective opinions. EY supported each of the proposals. PwC objected to giving shareholders the right to vote for a tender process to be conducted and enhancing the voting requirement for reappointment of an auditor to greater than a simple majority, but broadly supported the AEP Presentation Remedy and the ACC Q&A Remedy.

3.323 BDO was in favour of the remedy. GT supported the principle of enhanced shareholder-auditor engagement and broadly supported the AEP Presentation Remedy and ACC Q&A Remedy. GT opposed the Tender Voting Remedy and Enhanced Voting Remedy. 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. It considered that enhanced reporting was an issue to be dealt with by national or EU standard setters.

3.324 Details of the views of parties on enhanced shareholder engagement are set out in Appendix 3.5.

Effectiveness

3.325 In deciding which remedy design to pursue we considered the effectiveness of the options in addressing the provisional AEC. In doing so, we considered the effects of recent changes to AC and auditor reporting introduced by the FRC. These changes are discussed in further detail in paragraphs 3.430 to 3.438 under Remedy 6: Extended Reporting.

Voting remedies

3.326 The majority of respondents to our investor questionnaire were opposed to, or did not express a view on, these options. We noted that neither remedy directly improves the ability of shareholders to engage through increased transparency and information flow. We were not persuaded that the Enhanced Voting Remedy would be effective, since the level of shareholder engagement in auditor appointment decisions has historically been very low. On the other hand, requiring a special majority for this issue would not be appropriate; it would result in the appointment of the company auditor requiring greater support than election of a director, or the same amount of votes as required for winding up the company.

3.327 Accordingly, we have provisionally decided not to pursue the Tender Voting Remedy or the Enhanced Voting Remedy.

AEP Presentation & ACC Q&A remedy

3.328 We viewed AEP and ACC interaction at the AGM to be a potential mechanism for engagement with investors over matters concerning the audit. However, parties told us that AGMs were not well attended by investors, because of their perceived lack of utility, and also because the diversified shareholdings of institutional investors would require each investment company to send representatives potentially to thousands of AGMs, which were often clustered at similar times of the year. We think that there is scope for companies to reduce the obstacles faced by investors in attending AGMs. In particular, advances in technology may enable companies to webcast the AGM.

3.329 We noted that the ACC is already present at the AGM and available to answer questions.²⁰²

3.330 We had doubts that requiring the AEP to present at the AGM would serve to increase shareholder engagement any further, in particular, because we considered that there was a significant risk that AEP presentations would become ‘boilerplate’ owing to liability concerns.²⁰³

3.331 We have therefore provisionally decided not to pursue the AEP Presentation Remedy and the ACC Q&A remedy further. We think that ACCs being available to answer questions amounts to current best practice as required under the UK Corporate Governance Code.²⁰⁴ Therefore, we consider that the necessary mechanisms for shareholder engagement to take place at the AGM are already in place but are not

²⁰² The UK Corporate Governance Code and The FRC’s Guidance on Audit Committees provides that the ACC should be present at the AGM to answer questions, through the chairman of the board, on the AC report and matters within the scope of the AC’s responsibilities.

²⁰³ See evidence of Deloitte in Appendix 1(D).

²⁰⁴ Section E.2.3 UK Corporate Governance Code.

used effectively. We consider that with more information available to shareholders as a result of recent changes to the UK Corporate Governance Code (see paragraphs 3.430 to 3.432) and ISA 700 (see paragraphs 3.433 to 3.436), shareholders have the opportunity to engage with companies on audit issues at the AGM and/or at other appropriate forums. We would encourage companies and shareholders to ensure that AGMs are effective forums for engagement, for example by making use of technology, and by encouraging meaningful dialogue.

Post-remedies notice options

3.332 As described above (paragraph 3.316), following responses to the Remedies Notice from interested stakeholders and further reflection, we also considered the following design options.

- *Companies present two audit firms for a vote at the AGM*

3.333 We considered whether shareholders should be offered a choice of two possible auditors subsequent to a tender process.²⁰⁵

3.334 GT suggested that ACs propose two audit firms to shareholders upon completion of a tender process, with a duly justified preference for one. This would remove the final auditor appointment decision from management and the AC. In its view, this would provide a powerful rebuttal to the ‘IBM factor’ which currently exists in the auditor appointment decision.²⁰⁶

3.335 Deloitte did not support this proposal. In its view, management and the board were best placed to make the decision on choice of auditor. As a practical matter, it would

²⁰⁵ See paragraph 3.262 for a similar EU proposal.

²⁰⁶ [GT remedies response](#), paragraph 5.2.

be difficult to expect the non-preferred team to remain on standby in case shareholders did not opt for the preferred choice.²⁰⁷

3.336 KPMG considered that it would be very difficult for the AC to convey sufficient detail of the analysis it had done to enable shareholders to make an informed decision. If investors voted against the AC's choice, this would be tantamount to a vote of no confidence in the non-executives, with the position of the ACC becoming untenable.²⁰⁸

3.337 Companies that commented on this proposal during case study hearings were not supportive.

3.338 We concluded that this remedy option would not be effective. We were mindful that shareholders were not party to the detail of auditor appointment decisions and considered that the AC should be suitably empowered to take these decisions on shareholders' behalf. We also found practical difficulties with this remedy since the alternative choice of audit firm would need to be 'on standby' in case of a vote against the AC's recommendation. We considered that this would present considerable difficulties and could involve additional costs for companies. We are not therefore minded to pursue this remedy option.

- *Code amendments and advisory vote*

3.339 We considered the effectiveness of the following alternative options in encouraging shareholder engagement on audit issues:

(a) amendments to the UK Corporate Governance Code and the Stewardship Code to encourage shareholder engagement; and

²⁰⁷ [Deloitte response hearing summary](#), paragraph 55.

²⁰⁸ [KPMG response hearing summary](#), paragraph 64.

(b) the introduction of an advisory shareholder vote on the sufficiency of the level of detail in the Audit Committee Report.

UK Corporate Governance Code

3.340 Section E of the UK Corporate Governance Code deals with 'Relations with Shareholders'. The main principle of the section states: 'There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.'

3.341 This section contains the following two provisions:

E.1.1. The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend scheduled meetings with major shareholders and should expect to attend meetings if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.

E.1.2. The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion.

3.342 We think that audit-specific obligations, requiring the board to explicitly seek shareholder views on audit matters and explain how shareholder concerns have been addressed would enhance shareholder engagement. We propose the text in bold and underlined below:

E.1.1. The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss **audit**, governance and strategy with major shareholders. Non-executive directors, **notably audit committee chairs and members**, should be offered the opportunity to attend scheduled meetings with major shareholders and should expect to attend meetings if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.

E.1.2. The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion **and how any concerns of major shareholders may have been addressed.**

The Stewardship Code

3.343 The Stewardship Code was published in July 2010 and is maintained by the FRC. It sets out best practice for institutional investors when investing in UK listed companies and applies on a 'comply or explain' basis (see paragraphs 2.13 to 2.20). The Stewardship Code aims to enhance the quality of engagement between institutional investors and companies, thereby improving long-term returns to

shareholders, and ensuring appropriate exercise of governance responsibilities by investors.

3.344 The Stewardship Code is a set of seven key principles and guidance on how those principles may be implemented. Principle 3 provides that institutional investors should monitor their investee companies. Guidance in the Stewardship Code supporting this principle states that when monitoring companies, institutional investors should, among other things, keep abreast of the company's performance, satisfy themselves that the board adheres to the spirit of the UK Corporate Governance Code, and consider the quality of the company's reporting. Principle 4 provides that institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities. Guidance in the Stewardship Code supporting this principle provides that intervention should be considered regardless of whether an active or a passive investment policy is followed. Examples of when institutional investors may wish to intervene include where they have concerns about a company's strategy, performance, governance or approach to risks.

3.345 We think that these principles already have the potential to encourage institutional shareholders to engage on audit issues. However, we think that audit specific requirements added to these principles and related guidance, thereby expressly drawing the attention of institutional investors to the need to engage on audit issues, would contribute to enhancing shareholder engagement further.

3.346 We would recommend that the following text in bold be added to the Stewardship Code:

Principle 3

Institutional investors should monitor their investee companies.

Guidance

Effective monitoring is an essential component of stewardship. It should take place regularly and be checked periodically for effectiveness.

When monitoring companies, institutional investors should seek to:

- keep abreast of the company's performance;
- keep abreast of developments, both internal and external to the company, that drive the company's value and risks;
- satisfy themselves that the company's leadership is effective;
- satisfy themselves that the company's board and committees adhere to the spirit of the UK Corporate Governance Code, including through meetings with the chairman and other board members **including the Audit Committee chair and members**;
- consider the quality of the company's reporting **including its reporting on the external audit process**; and
- attend the General Meetings of companies in which they have a major holding, where appropriate and practicable.

....

Principle 4

Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

Guidance

Institutional investors should set out the circumstances in which they will actively intervene and regularly assess the outcomes of doing so. Intervention should be considered regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional investors may want to intervene include, but are not limited to, when they have concerns about the company's strategy, performance, governance, **external audit process**, remuneration or approach to

risks, including those that may arise from social and environmental matters.

Initial discussions should take place on a confidential basis. However, if companies do not respond constructively when institutional investors intervene, then institutional investors should consider whether to escalate their action, for example, by:

- holding additional meetings with management, **including Audit Committee chair and members**, specifically to discuss concerns;
- expressing concerns through the company's advisers;
- meeting with the chairman or other board members;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of General Meetings;
- submitting resolutions and speaking at General Meetings; and
- requisitioning a General Meeting, in some cases proposing to change board membership.

Advisory vote

3.347 We consider that changes to the UK Corporate Governance Code and Guidance on ACs introduced in September 2012 have the potential provide greater information on the audit process and how the AC has discharged its duty to assess the effectiveness of the external audit. However, this depends both on ACs complying with the relevant Code provisions and also on the adequacy of the information provided.

3.348 In assessing the effectiveness of the changes in AC reporting we considered the existing level of compliance with the provisions of the UK Corporate Governance Code (see paragraph 3.455 below). We noted that a minority of companies, 25 per cent, were fully compliant in 2012. Although compliance with audit-related

disclosures in the UK Corporate Governance Code has improved over time, compliance is not universal and the standard of disclosure is variable.

3.349 For this reason we believe that an advisory vote on the Audit Committee Report should be introduced to allow shareholders to indicate if the Audit Committee Report is providing sufficient information. The vote would be by definition advisory and, if the vote were not carried, would not require the AC to change its report; but the results will signal to the AC whether shareholders are satisfied that the AC has discharged its duties to shareholders appropriately. We would expect ACs to take into account the views of shareholders when preparing subsequent reports.

3.350 We see such votes as being an efficient way of giving shareholders the ability to express an opinion on whether a company has made sufficient and appropriate disclosures, without taking the more extreme steps of voting down the re-election of directors or voting against auditor reappointment. Currently advisory votes are required under the Companies Act 2006²⁰⁹ on the report of the Remuneration Committee and are framed in terms of whether or not shareholders approve the Remuneration Report. While the shareholders vote is not binding, as it is advisory, the negative publicity associated with a vote down should prompt the company concerned to address the specific shareholder issues raised. We note that the introduction of an advisory vote on the Remuneration Committee report has been powerful in enhancing shareholder influence over executive pay.

3.351 At present, shareholder engagement on audit is limited. Shareholders currently have powers in relation to accepting the annual report, appointing or reappointing an auditor and the re-election of directors (including members of the AC). The FRC considered that these existing shareholder powers were sufficient and was sceptical

²⁰⁹ See Companies Act 2006, section 439.

as to what the addition of an additional advisory vote would achieve. However, we have seen little evidence of shareholders using these powers. We believe this may be due to the perception that using these powers would be a 'nuclear option', alongside the lack of information allowing shareholders to use their powers appropriately.

3.352 We believe the introduction of the advisory vote will emphasize AC duties in this area and increase AC incentives to discharge their responsibilities in the interests of shareholders, in particular to assess the effectiveness of the external audit process and the approach taken to the appointment and reappointment of auditors. As a consequence, it will reinforce the role of the AC in the external audit relationship thus contributing to ensuring that competition is directed towards shareholder demand. We therefore believe that an advisory vote would be effective in contributing to remedying the distortion of demand we provisionally found.

3.353 In circumstances where a company has decided not to hold an advisory vote, we would expect the company to provide a full explanation as to its reasons. We consider that decisions not to hold an advisory vote would be rare in practice.

Assessment of effects

3.354 We think that the Corporate Governance Code and Stewardship Code principles already have the potential to encourage companies and shareholders to engage on audit issues. However, we think that audit-specific requirements added to these principles and related guidance, thereby expressly drawing the attention of companies and investors to the need to engage on audit issues, would contribute to enhancing shareholder engagement further.

- 3.355 We expect that an advisory vote will incentivize ACs to prepare Audit Committee Reports which are fully compliant with the FRC requirements and that, as a consequence, this will improve the overall level of information on AC activity and effectiveness for a given company. By increasing the visibility of AC activity and effectiveness, ACs will have heightened incentives to deliver on behalf of shareholders. It will therefore have an effect in addressing the distortion in competition we have identified.
- 3.356 We think that, by encouraging more information on how the AC has assessed the effectiveness of the external auditor, there will be some reinforcement of the importance of audit quality as an element of shareholder demand. As a result confidence in audit may be improved. We believe that there is a benefit to the UK as a result of increased confidence in audit quality and corporate governance.
- 3.357 We think that these additional measures will complement other measures to increase the availability of information on the external audit. These measures include recent changes to the UK Corporate Governance Code (see paragraphs 3.430 to 3.432) and ISA 700 (see paragraphs 3.433 to 3.436).
- 3.358 We believe that by implementing changes to both the Stewardship Code, addressed to institutional investors, and the UK Corporate Governance Code, addressed to companies, the effectiveness of the remedy will be greater than if either Code was amended without regard to the other.

Costs

- 3.359 Respondents to the Remedies Notice did not consider that costs for this proposed remedy would be extensive or disproportionate.

3.360 We believe that any amendment to the UK Corporate Governance Code will have a minimal additional cost to companies in either preparing the Audit Committee Report or holding an advisory vote. Our remedies in this area are no more than an emphasis and reinforcement of what is already regarded as best practice and, therefore, many companies will suffer limited additional costs as a result. We accept that some companies and ACs may be encouraged to adopt best practice as a result of these remedies but consider that any costs would be limited to the extra availability and work required of the ACC and AC members.

3.361 We do not believe there will be any direct costs for firms or investors as a result of our remedies in this area.

3.362 We have not identified any significant costs to the FRC beyond incorporating the changes proposed into the UK Corporate Governance Code and Stewardship Code.

Implementation of the remedy

3.363 We provisionally recommend to the FRC that the FRC amend section E of the UK Corporate Governance Code to require that the Board, and in particular the AC, seek shareholder views on audit issues and explain how any shareholder concern may have been addressed.

3.364 We provisionally recommend to the FRC that the FRC updates principles 3 and 4 of the Stewardship Code and related guidance to draw the attention of institutional investors to the need to engage on audit matters.

3.365 We provisionally recommend that the FRC amend the UK Corporate Governance Code requiring an advisory vote on the sufficiency of the level of detail in the Audit Committee Report.

- 3.366 The UK Corporate Governance Code applies to all companies with a Premium Listing.²¹⁰ We did not consider it necessary to limit the recommendations to apply only to FTSE 350 companies; good corporate governance is relevant for this wider class of public companies and we do not consider that the recommendation places a disproportionate burden on these companies.
- 3.367 We note that the Government has indicated that it will aim to have two common commencement dates each year for new legislation and regulations with a view to minimizing burdens on business. The commencement dates are 6 April and 1 October. While the UK Corporate Governance Code and Stewardship Code are not regulations, but rather both set out standards of good practice, their terms are applied by companies and investors alike on a comply or explain basis and, therefore, so far as possible we would aim to make use of these commencement dates.
- 3.368 On the basis that the CC makes its recommendation by October 2013, the statutory deadline for publishing its final report, the CC provisionally recommends that the elements of the remedies package relating to amendments to the UK Corporate Governance Code and the Stewardship Code have an implementation date of 6 April 2014.
- 3.369 With respect to the advisory vote, we anticipate that premium listed companies would hold their advisory vote on the sufficiency of the Audit Committee Report at the first AGM following the implementation of the recommended amendments into the UK Corporate Governance Code.

²¹⁰ The relevant section of the Listing Rules can be found at: <http://fsahandbook.info/FSA/html/handbook/LR/9/8>.

3.370 The CC welcomes views on the proposed remedy and the feasibility of the proposed timing.

Assessment of Remedy 5: Strengthening the accountability of the External Auditor

Summary

In order to strengthen the accountability of the external auditor to the AC, we have provisionally decided to make an Order to the effect that:

- For a FTSE 350 company, only the AC acting collectively or through the ACC is permitted to:
 - negotiate and agree audit fees and the scope of audit work;
 - initiate and supervise a tender process for external audit work and make recommendations for appointment of auditors following a tender process;
 - require replacement of an AEP; and
 - authorize the external audit firm to carry out any NAS.
- Further, the auditor should report any audit issue that the AEP considers to be material as soon as is practicable to the AC or ACC, having established the facts of the issue with finance or other relevant company staff.
- We intend that companies monitor and certify compliance with the Order in the Audit Committee Report.

Introduction

3.371 All UK listed companies are required to appoint a group of non-executive directors to serve as an AC with a particular responsibility to protect the interests of shareholders in relation to financial reporting and internal control.²¹¹ To fulfil this responsibility, corporate governance rules grant considerable authority to the AC in relation to external and internal audit. However, in the course of our investigation it has become apparent that, notwithstanding the formal authority of the AC, the FD and his/her staff have substantial influence and de facto responsibility for the negotiation of audit fees,

²¹¹ Provisional findings, paragraphs 3.25 & 3.26.

appointment and replacement of auditors, and conduct of a company's relationship with its auditors in general.

3.372 In this section, we set out:

- (a) our relevant provisional findings regarding the AEC and the proposals in our Remedies Notice;
- (b) how this remedy addresses the AEC and/or resulting customer detriment;
- (c) relevant context, and evidence in our provisional findings;
- (d) views of parties;
- (e) criticisms and variants of the proposed remedy;
- (f) method of implementation;
- (g) costs of the remedy;
- (h) design issues;
- (i) assessment of effects;
- (j) implementation; and
- (k) assessment.

Our relevant provisional findings and the proposals in our remedies notice

3.373 In our provisional findings we concluded that:

Misaligned incentives between auditors and shareholders and company management are a feature of the market that produces an AEC, namely that audit firms may compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ. This results in shareholder detriment as

auditors are not sufficiently independent from executive management and therefore insufficiently sceptical in carrying out audits.²¹²

3.374 We also considered in our provisional findings that:

we accept that the AC is an important and, by and large, powerful force in directing audit firms towards satisfying the demands of shareholders. However, we noted: (a) the scope for differences in interpretation as to the role of the AC; (b) the limited time and resources the AC had available to attend to audit-related matters; (c) that as part of the unitary board its position was less than wholly independent; and (d) the influential role of the FD in the conduct of the relationship with auditors, especially as regards appointment and reappointment. For these reasons, we do not think that ACs provide a comprehensive regulatory solution to the problems we have identified concerning a degree of lack of independence of external auditors.²¹³

3.375 In our Remedies Notice we proposed the remedy of 'strengthened accountability of the External Auditor to the Audit Committee' to reduce the influence of executive management in the relationship with the external auditor. To achieve this we specifically proposed that the AEP should report directly to the ACC 'such that only the AC and ACC would be able to negotiate audit fees, initiate tenders for audit work, require replacement of an AEP, authorize the external audit firm to carry out any non-audit assignments or conduct any other major aspect of the external audit relationship'.²¹⁴ We also proposed that the 'ACC would be the first point of contact if a material audit issue arose rather than only being consulted after the Finance

²¹² *ibid*, paragraph 13.7(a).

²¹³ *ibid*, paragraph 11.98.

²¹⁴ Remedies Notice, paragraph 48.

Director'.²¹⁵ The object of the measures is to ensure that 'the conduct of reporting relationships should be free of any material influence of the Finance Director on external audit such that the AC/ACC is solely and unambiguously the client of the AEP'.²¹⁶

How this remedy addresses the AEC and/or resulting customer detriment

3.376 The proposed remedy addresses the AEC by removing the incentives for audit firms to compete to satisfy executive management rather than shareholders. It seeks to do this by (a) clarifying the responsibility of the AC/ACC for external audit, whose interests should be closely aligned with the interests of shareholders and (b) substantially reducing the involvement and influence of the Finance Director and staff on all key aspects of the external auditor's engagement (tender processes, appointment, scope of audit, fees etc). The remedy therefore seeks to address the AEC rather than mitigating the effects.

3.377 This remedy does not address the AEC arising from our first theory of harm in our provisional findings, namely that companies lack bargaining power outside a tender process. This is addressed by other remedies in the proposed remedies package. It should be noted that with an increase in competitive pressure through the effect of these other remedies on our first theory of harm, it becomes even more important that competition is directed towards the shareholder demand. Hence strengthening the accountability of the external auditor to the AC is likely to have increased importance where the AEC arising from our first theory of harm is also effectively addressed.

²¹⁵ *ibid.*

²¹⁶ *ibid.*

Relevant context and evidence in our provisional findings

3.378 ACs were first proposed for UK listed companies by the Cadbury Report on corporate governance in 1992.²¹⁷ Since 1994 the Listing Rules have required listed companies to appoint an AC.

3.379 Requirements for ACs are backed by legislation. Article 41.1 of the EU Audit Directive (2006/43/EC) requires every PIE to have an AC which has at least four functions (a) to monitor the financial reporting process; (b) to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems; (c) to monitor the statutory audit of the annual and consolidated accounts; and (d) to review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

3.380 Current detailed requirements for ACs are set out in the Guidance on ACs as updated in September 2012 (paragraph numbers in the following text refer to this document). This guidance forms part of the UK Corporate Governance Code with which companies that have a Premium listing (including all FTSE 350 companies) must implement on a comply or explain basis. The Guidance on ACs clarifies that: 'While all directors have a duty to act in the interests of the company the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control' (1.3). However, 'nothing in the guidance should be interpreted as a departure from the principle of the unitary board. All directors remain equally responsible for the company's affairs as a matter of law. The audit committee ... remains a committee of the board. Any disagreement within the board, including

²¹⁷ Financial Aspects of Corporate Governance, December 1992.

disagreement between the audit committee's members and the rest of the board, should be resolved at board level' (1.4).

3.381 Thus the AC cannot be viewed as some form of supervisory board and this doctrine of the unitary board places some limits on the independence of the AC. However, 'the audit committee must be prepared to take a robust stand' (1.6) and where the AC cannot resolve a disagreement with the board to its satisfaction it should have the right to report to shareholders as part of its report contained in the annual report (3.5).

3.382 The Guidance on ACs frames the role of the AC as a high level, supervisory function but with some requirement to undertake detailed work. 'Many of the core functions of audit committees set out in this guidance are expressed in terms of 'oversight', 'assessment' and 'review' of a particular function' (1.8). 'However, the high-level oversight function may lead to detailed work. The audit committee must intervene if there are signs that something may be seriously amiss' (1.9).

3.383 In summary the Guidance on ACs sets out the responsibilities of the AC (2.2) as:

- (a) to monitor the integrity of the financial statements of the company including reviewing significant financial reporting judgements;
- (b) to review the company's internal financial controls;
- (c) to monitor and review the effectiveness of the company's internal audit function;
- (d) to make recommendations to the board in relation to the appointment of the external auditor. The AC should oversee any selection process for possible new appointees as external auditors and ensure that all tendering firms have such access as is necessary to information and individuals (4.21);
- (e) to approve the remuneration and terms of engagement of the external auditor.

The scope of the external audit should be reviewed by the AC with the auditor

and if it is not satisfied it should arrange for additional work to be undertaken (4.28). 'The audit committee should satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective, high quality, audit can be conducted for such a fee' (4.29);

(f) to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process; and

(g) to develop and implement policy on the engagement of the external auditor to supply non-audit services. The policy should specify the types of non-audit service that the external auditor is (1) pre-approved to supply, (2) can only supply with specific approval of the AC and (3) is excluded from supplying (4.39).

3.384 The Guidance on ACs was revised in September 2012. The major changes incorporated in the latest version included the need to put the audit out to tender at least every ten years, more informative reporting by the audit committee regarding key audit issues and the AC advising the board (where requested by the board) on whether the annual report is fair, balanced and understandable.

3.385 Despite the formal authority granted to the AC/ACC in overseeing external audit, we found that the FD and his/her staff often have considerable influence in the conduct of the company's relationship with external auditors. In practice the external auditors often appear to have a strong reporting line to the FD and a more distant, often mediated, reporting line to the ACC²¹⁸ notwithstanding the well qualified and experienced individuals normally appointed to the role of ACC.²¹⁹ The main elements of our assessment of the respective roles of the FD and ACC/AC are set out in Sections 9 and 11 of the provisional findings. Inter alia we found that:

²¹⁸ Remedies Notice, paragraphs 46 & 47.

²¹⁹ Provisional findings, paragraph 9.66.

- (a) FD's typically take the lead in the negotiation of the terms of the engagement, are involved in the agreement of work plans, and will discuss issues arising with the auditor prior to meetings with the AC. In contrast the ACC whilst involved in many of the same matters has an oversight role.²²⁰ The FD will typically have a 'no surprises' policy in which audit issues are discussed with the FD before being aired with the AC.²²¹
- (b) Despite the wide ranging formal responsibilities of the AC, we found that about 80 per cent of ACC respondents to our follow up survey indicated that they spent less than 2 days a month in their role as ACC for a particular company.²²²
- (c) Audit firms monitor appointments of new FDs (among other events) as potential trigger points for audit tender processes.²²³
- (d) In our first survey, FDs considered themselves to have significant influence in the appointment of auditors.²²⁴
- (e) Our case study evidence indicated that external auditor appointment is generally a joint decision between executive and non-executive management²²⁵ and executive management often had a key role in recommending particular firms.²²⁶
- (f) The FRC told us that in its experience the standard of corporate governance varied significantly from company to company.²²⁷
- (g) Beattie's study (2012) of AC and ACC engagement found, inter alia, incomplete engagement by ACs with key audit related issues and high engagement of the CFO (FD) with audit fees and NAS.²²⁸

²²⁰ *ibid*, paragraph 9.86.

²²¹ *ibid*, paragraph 9.69.

²²² *ibid*, paragraph 9.77.

²²³ *ibid*, paragraph 9.137.

²²⁴ *ibid*, paragraph 11.8.

²²⁵ *ibid*, paragraph 11.9.

²²⁶ *ibid*, paragraph 11.10.

²²⁷ *ibid*, paragraph 11.40.

²²⁸ *ibid*, paragraph 11.45.

Views of parties

- 3.386 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 the CC spoke in a series of case studies following publication of the provisional findings, had the opportunity to respond to the proposed remedy.
- 3.387 Investor groups²²⁹ strongly supported the proposed remedy. The Chartered Financial Analyst Society of the UK, for example, wrote that ‘currently the direct line of communication between the auditor and the financial director is too strong’.²³⁰
- 3.388 In their submissions, eight leading companies argued that the current arrangements, following the recent changes to the UK Governance Code worked well and that no additional powers or enhanced accountability were needed.²³¹ The GC100, representing general counsel and company secretaries in the FTSE 100, said that the revisions to the Code ‘should be allowed time to take effect before introducing any further remedies’.²³² The 14 other companies the CC interviewed at FD or ACC level (published as Case Studies) uniformly took the same view.²³³
- 3.389 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.

²²⁹ The Universities Superannuation Scheme Limited, 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.

²³⁰ CFA remedies response.

²³¹ 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).

²³² GC100 response to PFs and remedies notice.

²³³ See Appendix 1.1.

3.390 GT, for example 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).²³⁴

Criticisms and variants of the proposed remedy

3.391 Despite accepting the principle of strengthening the AC, many respondents argued that the remedy 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.

3.392 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;
- (b) making the AC the first point of contact if a material issue arises; and
- (c) the issue of executive responsibility: 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'.²³⁵

3.393 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. This would enable the three-way dialogue

²³⁴ Grant Thornton remedies response, Appendix, paragraphs 4.1–4.3.

²³⁵ For example, EY response to provisional findings and remedies notice, Annex 2, paragraph 6.7.

between management, auditors and the AC to be maintained. It would also ensure that management and shareholders understand that the AC is primarily responsible for the appointment and oversight of the auditor.²³⁶

- (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 FD²³⁷). 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.
- (c) The AC could also be given responsibility for when to go out to tender and rotate, the tender process and auditor appointment (as supported by, for example, GT²³⁸).
- (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 is fully informed of the facts necessary to form a judgement.²³⁹

Method of implementation

3.394 Respondents generally considered that any changes could be achieved by building on the current guidance on the role of the AC.

Costs of the remedy

3.395 Respondents generally agreed with the CC's assessment that the remedy would involve direct costs in terms of the additional time commitment required of AC members but that these were sustainable.

²³⁶ [Deloitte remedies response](#), paragraph 7.5(a).

²³⁷ [Ernest & Young response to provisional findings and remedies notice](#), Annex 2, paragraph 6.9.

²³⁸ [Grant Thornton remedies response](#), Appendix, paragraphs 4.4 & 4.5.

²³⁹ [PwC response to provisional findings and remedies notice](#), paragraph 3.56.

3.396 A few respondents (including Kingston Smith²⁴⁰ and Deloitte²⁴¹) 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 companies²⁴² interviewed by the CC took this view, (eg the ACC of Company L).²⁴³

3.397 Details of the views of parties on strengthening the auditor's accountability to the AC are set out in Appendix 3.6.

Design issues

3.398 The main design issues that arise in relation to this remedy are as follows:

- (a) the first point of contact issue;
- (b) AC/ACC being in sole charge of major audit engagement features;
- (c) the issue of 'executive responsibility';
- (d) whether time should be allowed to assess FRC changes to AC guidance; and
- (e) whether 'comply or explain' is sufficient for this proposed remedy.

3.399 We discuss each of these issues in turn.

First point of contact

3.400 In our Remedies Notice we proposed that 'the ACC would be the first point of contact if a material audit issue arose rather than only being consulted after the Finance Director²⁴⁴'. This was a response to the policy of 'no surprises' apparently pursued by some FDs which may have the potential to delay visibility of audit issues or ensure

²⁴⁰ Kingston Smith response to provisional findings and remedies notice.

²⁴¹ Deloitte remedies response, paragraph 7.6(b).

²⁴² See www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/case-studies.

²⁴³ Company L, paragraph 28.

²⁴⁴ Remedies Notice, paragraph 48.

that AC discussion effectively deals with a fait accompli. This might undermine the independence of auditors.

3.401 This proposal prompted significant concerns as to its practicability (see paragraphs 3.386 to 3.402). It was felt that the AEP should establish the facts of an issue in discussion with the FD and his team before raising this with the AC/ACC. It was also felt that such rapid reporting would also require an unrealistic day-to-day involvement of the ACC. The comments of the FRC are also pertinent (see paragraphs 3.387, 3.389 and 3.390) in noting that the revised Guidance on ACs has recently introduced extended reporting requirements to reduce the risk that issues are resolved between the finance director and auditor without reference to the AC.

3.402 In view of the above points we consider that this aspect of the proposed remedy should be reformulated in terms of the auditor being obliged to report any audit issue that the AEP considers material as soon as practicable to the ACC/AC, having established the facts of the issue with finance staff. This should ensure timely notice of material issues to the ACC/AC without requiring a substantial increase in day-to-day involvement from the ACC. In addition, this does not create ambiguity in the FD's responsibility for production of the accounts.

Responsibility for major audit engagement features

3.403 In our Remedies Notice we proposed that 'only the AC and the ACC would be able to negotiate audit fees, initiate tender processes for audit work, require a replacement of an AEP, authorize the external audit firm to carry out any non-audit assignments or conduct any other aspect of the external audit relationship²⁴⁵'. This proposal seeks to remove the influence of the FD and his staff on the conduct of the audit relationship and therefore removes incentives for auditors to compete for management approval.

²⁴⁵ *ibid.*

3.404 There appeared to be general support from respondents to this proposal in principle. However, there were some concerns about how unwieldy this responsibility might be for the ACC and there was some concern from ACCs and FDs that ACCs did not have access to sufficient detail to negotiate audit fees.

3.405 With regard to the suitability of AC/ACCs negotiating audit fees, we note that we have previously concluded that ACCs are, in general, well qualified and experienced for their roles.²⁴⁶ This proposal does not preclude ACCs from consulting others either within or outside the company to obtain information to support negotiations. In addition, more frequent tender processes will provide the AC with regular information about the competitive level of fees. Current guidance (paragraph 4.29 of the Guidance on ACs) also requires ACs to satisfy themselves that ‘the level of fee payable in respect of audit services is appropriate’. It is difficult to understand how the AC can discharge this current requirement adequately if it does not already have a good understanding of the basis of audit fees.

3.406 For the above reasons we consider that ACC/ACs will be equipped to be competent and effective in negotiating and agreeing audit fees. It is possible that in certain circumstances that the ACC may not negotiate as hard as the FD on audit fees in order to preserve audit quality. If so, this should not be regarded as a cost to the company but rather as a choice of quality and pricing that is likely to be more closely aligned with the preferences of shareholders, given the particular responsibilities of the ACC/AC. The ACC/AC negotiating audit fees provides a clear and unambiguous demonstration that the ACC/AC is in charge of managing the audit relationship rather than the FD.

²⁴⁶ Provisional findings, paragraph 9.66.

3.407 In view of the above considerations, we recommend that the ‘major audit engagement feature’ of the proposed remedy is broadly maintained as proposed in the Remedies Notice and is formulated as follows:

For a FTSE 350 company only the AC acting collectively or through the ACC is permitted to:

- (a) negotiate and agree audit fees and the scope of audit work;
- (b) Initiate and supervise tender processes for external audit work and make recommendations for appointment of auditors following a tender process;
- (c) require replacement of an AEP; and
- (d) authorize the external audit firm to carry out any NAS.

The issue of executive responsibility

3.408 Some respondents raised concerns (see paragraphs 3.391 and 3.392) that adding responsibilities to the role of the AC or ACC for external audit would transform these into an executive function and therefore negate their independence.

3.409 Under the UK Corporate Governance Code (section A4) non-executive directors ‘should constructively challenge and help develop proposals on strategy’ and ‘Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance’. Increasing the responsibility of the AC/ACC for external audit does not imply that their role aligns their function with executive directors and becomes less independent. On the contrary, having greater responsibility for external audit should enable the non-executive directors sitting on the AC to fulfil their responsibilities more effectively for holding the executive to account and monitor the reporting of performance.

3.410 As currently formulated, this proposed remedy will necessitate some intensification of the involvement of the AC/ACC although this should not be so significant as to fundamentally change the basis of their role. However, the requirement for increased involvement will need to be recognized in an appropriate transitional period to allow companies/non-executive directors to resource the proposed changes adequately. This will be considered further under the implementation section below.

Allowing time to assess FRC changes to AC guidance

3.411 Some respondents have argued that the recent revisions to the UK Corporate Governance Code should be allowed to take effect before introducing further changes (paragraph 3.388).

3.412 The FRC's main recent changes are summarized in paragraph 3.384. This proposed remedy has taken account of the changes. However, the FRC's changes do not address the particular purpose of this remedy and in order to comprehensively address the AEC that we have provisionally identified, it is necessary to go beyond the FRC's recent changes.

Sufficiency of comply or explain

3.413 Most respondents in commenting on implementation of this remedy (paragraph 3.394) consider that implementation should be achieved through some form of change in the UK Corporate Governance Code. This in turn would imply that the provisions would be subject to comply or explain principles only.

3.414 Comply or explain principles are well suited to situations which need to accommodate a variety of practice. However, it is less clear that this is desirable where compliance is needed with specific requirements. The FRC has told us that the standard of corporate governance varies significantly from company to

company.²⁴⁷ To ensure effective implementation it may be necessary to incorporate the measures in an Order rather than being subject to the lighter standard of comply or explain.

Assessment of effects

3.415 In paragraph 3.374 above we noted our provisional finding that there were particular shortcomings in the operation of ACs at present that prevent ACs being a comprehensive solution to the problems we have identified concerning a lack of independence of auditors. If successfully implemented this remedy should significantly reduce these shortcomings namely by:

- (a) reducing the scope for differences in interpretation as to the role of the AC; and
- (b) reducing the influential role of the FD in the conduct of the relationship with auditors.

3.416 In addition, by more clearly specifying the expectations of the role of the AC, the risk of limited time and resources for the AC may be at least partially addressed. We accept that there may be some residual threat to the independence of the AC by virtue of AC members belonging to a unitary board.

3.417 The successful implementation of this remedy may therefore significantly reduce the risk that competition between audit firms is distorted to satisfy management rather than shareholders. This should reduce the risk of shortfalls in audit quality/ independence and increase the confidence that investors have in reported results and company governance although, as noted above, it may not remove all independence concerns. This assessment is supported by the strong approval of investor groups for this remedy noted in paragraph 3.387 above.

²⁴⁷ Provisional findings, paragraph 11.40.

3.418 The remedy is unlikely to result in a significant change in the costs of audit firms. The proposed remedy has also been tailored to ensure that it does not require a substantial increase in day-to-day involvement from the ACC (as per paragraph 3.402). However, the increased overall involvement of ACs in general and ACCs in particular is likely to increase company costs for the time expended by ACs/ACCs (as noted by respondents in paragraph 3.395). The possibility (noted in paragraph 3.396) of the increased responsibilities on ACCs resulting in a diminution in the supply of suitably qualified people to act as ACCs may also result in an increase in the rate payable for ACC roles. However, the increase in costs of ACs may be offset to a significant degree by the FD and staff spending less time on negotiating audit fees and the terms and scope of audit engagements. The aggregate incremental cost for each company is therefore unlikely to be significant. If this totalled £30,000 a year for each company in the reference market this would result in an aggregate market cost of £10.5 million a year. Although this is a significant absolute sum it is a small amount compared with the turnover, profit and market capitalization of the companies concerned and with the effect of small improvements in investors' perceptions of the risks of companies on their cost of capital. This will be considered further in the proportionality section of this paper.

Implementation

3.419 In practice we think there are two main options for implementing our proposals on strengthening ACs:

- (a) relying on recommendations to the FRC to incorporate desired changes in the UK Corporate Governance Code and/or Guidance on ACs; and
- (b) incorporating the proposals into a CC Order.

3.420 In general, the CC prefers to act by Order where possible and appropriate, as an Order is binding and we have the power to make it directly. An Order is therefore

more likely to be effective in addressing the identified AEC. We do not think that a recommendation to the FRC will fully achieve the aims of this remedy proposal.

- 3.421 We therefore have provisionally decided to issue an Order addressed to FTSE 350 companies and firms to the effect that only the AC acting collectively or through the ACC is permitted to: (a) negotiate and agree audit fees and the scope of audit work; (b) initiate and supervise tender processes for external audit work and make recommendations for appointment of auditors following a tender process; (c) require replacement of an AEP; and (d) authorize the external audit firm to carry out any NAS.
- 3.422 Further the auditor should report any audit issue that the AEP considers to be material as soon as is practicable to the AC/ACC, having established the facts of the issue with relevant finance and other staff.
- 3.423 We would require a compliance statement to be included as part of the Audit Committee Report to the effect that the company has complied with the provisions of the proposed Order.
- 3.424 On the basis that a final Order will be made approximately six to nine months after the publication of the CC's final report, the statutory deadline for which is October 2013, we consider the Order should have an application date of 1 October 2014 in line with the government-recommended commencement dates (see paragraph 3.367). The requirements of the proposed Order should come into effect fully for statutory audit engagements entered into on or after 1 October 2014.
- 3.425 We have taken into account that the FTSE 350 is a 'shifting class' with companies periodically moving in or out of the listing. We are currently minded to provide that

new entrants to the FTSE 350 listing are to be subject to the provisions of the proposed Order immediately upon entry into the listing. We are of the view that the proposed Order reflects good corporate governance which companies with aspirations to join the FTSE 350 are likely to follow, and in any event the requirements of the proposed Order can be taken into account and planned for by companies just outside the FTSE 350 listing. We would not therefore expect the provisions to be unduly onerous on companies entering the FTSE 350 listing. The CC welcomes views on the proposed remedy and on the feasibility of the proposed timing for application of the Order.

Assessment

3.426 We consider that this remedy is likely to make an effective contribution to addressing our provisional finding of an AEC whereby audit firms compete to satisfy management rather than shareholder demand. The costs incurred by this remedy are also likely to be small compared with the beneficial effects of this remedy on audit independence and perceived audit quality. We provisionally decide that we will proceed with this remedy as an element in a package of effective remedies designed to create a comprehensive solution to the identified AEC.

Assessment of Remedy 6: Extended reporting requirements—in both the AC’s and auditor’s report

Summary

We provisionally recommend to the FRC that it should amend the UK Corporate Governance Code to include the following additional provision in relation to the Audit Committee Report:²⁴⁸

In reporting how the AC has assessed the effectiveness of the auditor, the AC should report on (i) whether the AQR team has concluded a review on the audit of the company’s financial statements in the reporting period, (ii) what the principal findings were, including grade, and (iii) how both the AC and auditor are responding to these findings.

Introduction

3.427 In our provisional findings we found that shareholders had little or no information about the quality of the audit or the audit process with which to engage with companies on matters concerning the external audit and that shareholder demand for more information was not being met.²⁴⁹ We found that companies had little visibility of the quality of other audit firms.²⁵⁰ We considered that a remedy which encouraged the AC or the auditor to disclose information about the audit would be helpful in addressing this lack of information.

3.428 In our Remedies Notice we asked four questions ((a) to (d) below) on how this remedy option might be developed:

- (a) How may we best support the FRC in establishing enhanced reporting and whether there are other avenues, including direct measures by the CC, that should also be pursued?
- (b) What should be the scope and form of enhanced reporting proposals? For example:

²⁴⁸ The UK Corporate Governance Code is applied by all companies with a Premium Listing (for a definition of ‘Premium Listing’ see <http://fsahandbook.info/FSA/html/handbook/LR/9/8>). We do not consider it necessary to limit the recommendation to apply only to FTSE 350 companies for the reasons as set out in paragraph 3.366. The analysis in this section of the PDR focuses on the benefits of the proposed remedy for the FTSE 350; however, we consider that the discussed benefits would equally apply to all companies with a Premium Listing.

²⁴⁹ Provisional findings, paragraph 12.

²⁵⁰ Provisional findings, paragraph 19.

- (i) whether further disclosure should be made via the Audit Committee Report or the auditor's report;
 - (ii) what the content of the additional disclosure should be; for example, should this be some form of commentary on how the company's interpretation of the accounting standards compares with the norm; or commentary on the main topics of debate between auditor and management; and
 - (iii) what guidance as to the form of the disclosure should be required.
- (c) What costs and benefits would arise as a result of this remedy?
- (d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

Structure of this section

3.429 In this section we:

- (a) outline recent regulatory developments concerning disclosures in the Audit Committee Report and the Audit Report;
- (b) set out the responses to the Remedies Notice;
- (c) assess the effectiveness of the recent changes made to the Audit Committee Report and Audit Report at addressing the AEC that we have provisionally found;
- (d) consider whether further remedies are required, and if so:
 - (i) how these might be designed;
 - (ii) what their effect would be; and
 - (iii) implementation.

Recent changes to Audit Committee Reports and Audit Reports

Audit Committee Reports

3.430 In the December 2010²⁵¹ Guidance on Audit Committees, ACs were required to report annually, as part of the Directors' Report, the following:²⁵²

- (a) a summary of the role of the AC;
- (b) the names and qualifications of all members of the AC during the period;
- (c) the number of AC meetings;
- (d) a report on the way the AC has discharged its responsibilities; and
- (e) how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors;²⁵³ and
- (f) how, if the auditor provides NAS, auditor objectivity and independence is safeguarded.^{254,255}

3.431 In April 2012 the FRC issued the consultation document 'Revisions to the UK Corporate Governance Code and Guidance on Audit Committees'²⁵⁶ on proposed changes to policies.²⁵⁷ One of the expected changes was that 'more informative reporting by ACs, including on the process for appointing the external auditor, will be encouraged'.²⁵⁸ The outcome of this consultation was the September 2012 revision to the Guidance (applicable to companies whose reporting period began on 1 October 2012) to require the Audit Committee Report to include:

- (a) the significant issues that the AC considered in relation to the financial statements and how these issues were addressed, having regard to matters communicated to it by the auditors; and

²⁵¹ This was the last version issued before the September 2012 revision.

²⁵² Some requirements were introduced prior to December 2010.

²⁵³ 4.23 This explanation should normally include supporting information on tendering frequency, the tenure of the incumbent auditor, and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

²⁵⁴ 4.37 This includes the policy on appointing the auditor to provide NAS.

²⁵⁵ Guidance on Audit Committees, Financial Reporting Council, December 2010, paragraph 5.2.

²⁵⁶ FRC, 'Revisions to the UK Corporate Governance Code and Guidance on Audit Committees', April 2012.

²⁵⁷ This had followed the publication by FRC of 'Effective Company Stewardship: Next Steps', September 2011.

²⁵⁸ FRC, 'Revisions to the UK Corporate Governance Code and Guidance on Audit Committees', April 2012, paragraph 3.

(b) an explanation of how the AC had assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor,²⁵⁹ and information on the length of tenure of the current audit firm, when a tender process was last conducted, and any contractual obligations that acted to restrict the AC's choice of external auditors.²⁶⁰

3.432 The first of these provisions was a new addition to the guidance and the second was a revision to previous requirements. Most significantly, these paragraphs were also included in the UK Corporate Governance Code.²⁶¹ Whilst companies do not need to comply with provisions in the Corporate Governance Code, they should explain why divergence is justified and how governance has been achieved.²⁶²

The Auditor's Report

3.433 The FRC is responsible for issuing ISAs in the UK and Republic of Ireland, having regard to the pronouncements of the IAASB. The UK and Republic of Ireland version of ISA 700 'The Auditor's Report on Financial Statements' was revised in October 2012 and in June 2013.²⁶³

3.434 Prior to the revisions of October 2012, the principal elements of the audit report were:

- (a) an introduction listing the financial statements of the entity that had been audited;
- (b) the respective responsibilities of Those Charged with Governance and Auditors;
- (c) an explanation of the scope of the audit;

²⁵⁹ Specifically in order that shareholders can understand why the AC recommended either to reappoint or change the auditors (paragraph 4.26).

²⁶⁰ Guidance on Audit Committees, Financial Reporting Council, September 2012, paragraph 5.2. Subparagraph B was a redrafting of existing guidance in the December 2010 version.

²⁶¹ This wording is supplicated in the UK Corporate Governance Code, September 2012, paragraph C.3.8.

²⁶² FRC, UK Corporate Governance Code, September 2012, paragraph 3.

²⁶³ The standard is now ISA (UK & I) 700—The independent auditor's report on financial statements (June 2013).

- (d) the opinion on the financial statements, ie whether or not the financial statements are ‘true and fair’ (including a statement on the relevant accounting framework²⁶⁴) and any necessary modification of the opinion; and
- (e) the opinion on other matters, such as whether the Directors’ Report is consistent with the financial statements.²⁶⁵

3.435 The October 2012 revision to ISA 700 introduced a requirement for the auditor to report by exception ‘if the board’s statement that the annual report is fair, balanced and understandable is inconsistent with the knowledge acquired by the auditor in the course of performing the audit, or if the matters disclosed in the report from the audit committee do not appropriately address matters communicated by the auditor to the committee’.²⁶⁶ These changes were aimed at supporting changes to the UK Corporate Governance Code to enhance effective stewardship.²⁶⁷

3.436 In February 2013, the FRC published a consultation document on revising ISA 700, including an invitation to comment on an exposure draft of a revised ISA 700 applicable to those entities that apply the UK Corporate Governance Code. Following this consultation, a revised ISA 700 was issued in June 2013. ISA 700 now requires auditors to:

- (a) describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;
- (b) provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit; such explanation shall specify the threshold

²⁶⁴ For listed entities, this will be IFRS.

²⁶⁵ In addition, some entities may be issued with a second opinion on another financial reporting framework, such as IFRSs issued by the IASB and IFRSs as adopted by the EU.

²⁶⁶ www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-issues-revised-auditing-standards-to-enhance-c.aspx.

²⁶⁷ Paragraphs 5 & 6. Revision to ISA (UK and I) 700 Requiring the auditor’s report to address risks of material misstatement, materiality and a summary of the audit scope, Financial Reporting Council, February 2013.

used by the auditor as being materiality for the financial statements as a whole;
and

(c) provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement disclosed in accordance with (a) and was influenced by the auditor's application of materiality disclosed in accordance with (b).²⁶⁸

3.437 The IAASB describes auditor reporting as its number one priority²⁶⁹ and has been undertaking a series of consultations on developing the auditors' report through amending the ISAs since 2011. In a meeting of the IAASB in February 2013, support was given to a new objective of the auditor: 'The objective of the auditor, having formed an opinion on the financial statements, is to communicate in the auditor's report those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements.'²⁷⁰

3.438 This new objective is tentatively expected to result in the creation of a new ISA, ISA 701. The IAASB will produce an exposure draft of any revisions to the ISAs in 2013 with the final revised ISAs approved in June 2014.

European reforms

3.439 The European Commission published a green paper²⁷¹ and conducted a consultation on its contents in 2010. The green paper made reference to the possibility of revising the content of the audit report to provide more information to stakeholders. Having

²⁶⁸ ISA (UK & I) 700, paragraph 19A.

²⁶⁹ www.ifac.org/auditing-assurance/auditor-reporting-iaasbs-1-priority.

²⁷⁰ www.ifac.org/sites/default/files/meetings/files/20120214-IAASB-February-2013_Meeting_Highlights-final.pdf.

²⁷¹ http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf.

received responses to the consultation²⁷² the European Commission published a draft proposal for a regulation on statutory audit of PIEs in November 2011.²⁷³

3.440 The proposal stated that:²⁷⁴

The content of the audit report disclosed to the public is expanded so that it explains the methodology used, especially how much of the balance sheet has been directly verified and how much has been based on system and compliance testing, the levels of materiality applied to perform the audit, the key areas of risk of material misstatements of the financial statements, whether the statutory audit was designed to detect fraud and, in the event of a qualified or adverse opinion or a disclaimer of opinion, the reasons for such a decision. It should also explain the variation in the weighting of substantive and compliance testing when compared to the previous year.²⁷⁵

Moreover, the auditor should also prepare a longer and more detailed report for the audit committee. This report would provide more detailed information on the audit carried out, on the situation of the undertaking as such (e. g. going concern) and the findings of the audit combined with the necessary explanations. This additional report would also present (and justify) the audit work carried out to the audit committee. This longer report would be submitted to the audit committee and to the management of the audited entity, but not to the public (given that its content would include business secrets and potentially price sensitive

²⁷² A summary of responses was published in February 2011
http://ec.europa.eu/internal_market/consultations/docs/2010/audit/summary_responses_en.pdf.

²⁷³ http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf.

²⁷⁴ http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf, paragraph 7.

²⁷⁵ This is expanded on in article 22 of the proposed regulation.

information). However, upon request, the auditor should make this report available to the competent authority.²⁷⁶

3.441 This proposal continues to be discussed in the European Parliament. With respect of reporting, in April 2013 the Legal Affairs Committee (JURI) voted to require PIE auditors to ‘provide shareholders and investors with a detailed understanding of what the auditor did and an overall assurance of the accuracy of the company's accounts’.²⁷⁷ Given the ongoing process we do not comment in detail on the expected outcome.²⁷⁸

Remedies Notice and responses

3.442 We reviewed the responses to the Remedies Notice and other evidence relating to this proposed remedy from the remedies hearings, the case studies with companies, and questionnaire responses from investors.

3.443 In our Remedies Notice we stated that this remedy would override the reluctance of management to disclose information about the audit process and would thereby enhance transparency. This in turn was expected to improve the ability of companies and shareholders to judge audit quality, thus reducing switching costs and improving the ability of shareholders to influence the auditor selection decision.

3.444 We said:

In the course of our inquiry it has become apparent that there is significant institutional investor dissatisfaction with the relevance and extent of reporting in audited financial reports. We are aware that there are ongoing discussions within the industry led by regulatory bodies

²⁷⁶ This is expanded on in Article 23 of the proposed regulation.

²⁷⁷ www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bIM-PRESS%2b20130422IPR07532%2b0%2bDOC%2bXML%2bV0%2f%2fEN&language=EN.

²⁷⁸ See paragraphs 2.23–2.27 for information on the progress of European-Union-led reforms to audit.

such as the FRC and International Auditing and Assurance Standards Boards as to whether and how audit reports and financial statements can be enhanced to increase their value to shareholders. We support the broad view for enhanced disclosure and consider that this would help to address adverse effects that we have found.

3.445 Our review of responses indicates that there is widespread support for enhanced reporting by ACs and auditors. We found, however, that there is less consensus on the specific scope of this extended reporting and on the issue of whether it should be by both the AC and the auditor. However, the view that the FRC was the appropriate body to advance this remedy was almost unanimous.

3.446 Companies did not generally favour additional disclosure in the AC or auditor report, with some noting the need to consider the burden on the lay reader. The largest and Mid Tier firms were supportive of improved reporting and supported the work of the FRC and IAASB. Some firms favoured additional reporting in the annual report rather than the audit report. Regulators and professional bodies in the UK and internationally supported the work of the FRC and the IAASB.

3.447 Further details on the views of parties about this proposed remedy are given at Appendix 3.7.

Assessment of effectiveness of recent FRC reporting initiatives

3.448 The recent changes made by the FRC to AC and auditor reporting had either not taken effect or had not been finalized at the point at which our provisional findings were published. We now consider the extent to which these reporting changes address the AEC that we have provisionally found.

3.449 The FRC's recent changes to AC reporting introduced in the UK Corporate Governance Code apply to reporting periods beginning on or after 1 October 2012.²⁷⁹ The majority of FTSE 350 companies will publish reports prepared under the new guidance in the first half of 2014, hence it is difficult to assess their effectiveness in practice at this stage.

3.450 In relation to the audit report, the FRC had not concluded its consultation on ISA 700 at the point of publishing the Remedies Notice or the provisional findings. Since their publication, the FRC has finished work on ISA 700. The IAASB's consultation on auditor reporting continues at an international level.

Audit Committee Reporting

3.451 The 2012 revisions to the Guidance on ACs and UK Corporate Governance Code (see paragraph 3.431) saw the introduction of the requirement for ACs to include an assessment of auditor effectiveness and to explain how the decision to appoint or reappoint was made. This had previously been included in guidance to ACs, and its promotion to the UK Corporate Governance Code places an increased emphasis on AC reporting. In addition (per paragraph 3.431), ACs are now required to communicate the significant issues that the committee considered in relation to the financial statements and how these issues were addressed, having regard to matters communicated to it by the auditors.

3.452 We believe that the expanded reporting requirements in the 2012 UK Corporate Governance Code have the potential to contribute towards remedying unmet shareholder demand for information on the audit and to towards remedying the distortion of demand that we provisionally found. We consider this is partly

²⁷⁹ This applies to all companies subject to the Corporate Governance Code.

dependent on the extent to which companies comply with the new requirements and the quality of the disclosures that they make.

- 3.453 Any requirement for the AC to report under the UK Corporate Governance Code is on a 'comply or explain' basis. Under 'comply or explain' any disclosure will necessarily be voluntary and cannot be enforced (see paragraphs 2.4 and 2.5). The effectiveness of any remedy is therefore dependent on the willingness of companies to comply.
- 3.454 On the basis of the level of overall compliance with the UK Corporate Governance Code, we believe that ACs will comply with aspects of these requirements, as total non-compliance is rare. However, GT's review of corporate governance disclosures indicates that disclosures on matters relating to external audit have not consistently been of a high quality.
- 3.455 Figure 1, drawn from GT's review indicates that disclosures on the appointment of auditors²⁸⁰ have improved over the period 2009 to 2012 but that 14.5 per cent of the FTSE 350 fail to make any disclosure²⁸¹ and only 25 per cent of companies are categorized in the most compliant category.²⁸² This would indicate that the enhanced AC reporting will not be a fully effective remedy, as it will not be implemented by all companies and not all shareholders will benefit, and the trend of compliance with previously introduced measures suggests that compliance with the new measures may take some time to be adopted widely.²⁸³

²⁸⁰ This section of the AC report should include an explanation of how the AC has assessed the effectiveness of the external audit process (UK CGC C.3.8).

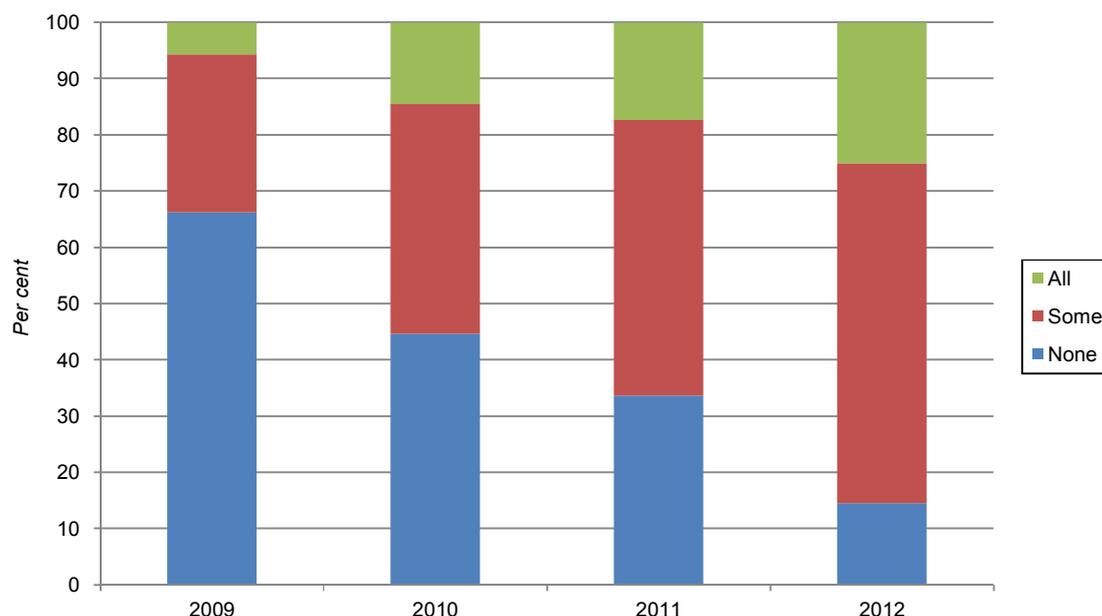
²⁸¹ This is companies which fail to comply or to explain their lack of compliance.

²⁸² GT's highest category is 'More', which is achieved where a company provides a detailed explanation to support each area of the Code with which they choose not to comply. This includes the reasons for their non-compliance, an explanation as to why they feel that this non-compliance is in the best interests of the company and the shareholders, a description of mitigating actions taken and, where appropriate, when the company intends to comply with the provision. 2012 GT Corporate Governance Review, p41.

²⁸³ The annual reports reviewed were not required to adopt the most recent changes to the Corporate Governance Code, and it seems like that compliance with any new requirement would be even lower in the first years after introduction.

FIGURE 1

How much information the AC reports on its recommendation to the board on the appointment, reappointment or removal of external auditors?



Source: Grant Thornton Corporate Governance Review, Figure 48.

3.456 Under the FRC’s ISA 700 (October 2012), auditors are required to report ‘if when reading the other financial and non-financial information included in the annual report, the auditor has identified information that is materially inconsistent with the information in the audited financial statements or is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit or that is otherwise misleading.’²⁸⁴ We think this provides a safeguard against ACs disclosing incorrect or misleading information but is unlikely to prevent examples of limited or partial disclosure.

3.457 However, based on the above assessment, we did not think that the changes would be effective in all cases and were concerned that the extent of disclosure and quality of disclosures might be limited in some cases. We are recommending two additional measures to improve the quality of AC reporting:

²⁸⁴ ISA 700 (UK & I) October 2012, paragraph 22A.

- (a) We recommend that an advisory vote be introduced on the Audit Committee Report, whereby shareholders are asked to approve the sufficiency of disclosure in the Audit Committee Report. This aspect of our remedy package is discussed in further detail in Enhanced Shareholder Engagement. (see paragraph 3.348)
- (b) We consider that the AC should disclose the outcome of any AQR team findings on the company's audit to its shareholders. As discussed in the AQR remedy (see paragraph 3.214), we consider that an AQR review is the only available independent assessment of technical audit quality. For this reason, in conjunction with our remedy on increasing the frequency of AQRs, we believe that ACs should report explicitly on any findings arising from an AQR of the company's audit and how the AC has used that AQR in assessing the effectiveness of the auditor. This gives shareholders more meaningful information on how the AC has ensured that shareholder interests in a high quality audit are taken into account. It would also increase visibility of technical audit quality.

Audit reports

- 3.458 We consider that the changes to ISA 700 will increase availability of information on the audit approach applied to specific audit engagements. We consider that this information will assist companies to compare the quality of their own audit with that of other firms, and will contribute to addressing the lack of bargaining power that we provisionally found.
- 3.459 The increased disclosures in the audit report will also provide shareholders with more information with which to judge the quality of the audit, and potentially to form the basis of engagement with companies, and the AC in particular, on the audit approach. As a result, ACs may better understand shareholder demands and reflect these demands in managing the audit relationship and in auditor appointment decisions.

- 3.460 For example, as the materiality threshold used by the auditor will now be disclosed, firms could choose to compete by offering an enhanced audit service with a lower materiality threshold, which could potentially provide greater assurance to shareholders.²⁸⁵
- 3.461 In assessing the effectiveness of the revised ISA 700, we considered the likely extent of compliance. As International Standards on Auditing are mandatory for FTSE 350 company audits we consider that compliance will be universal in terms of making the minimum required disclosures.²⁸⁶
- 3.462 We note that much of the information required to be disclosed under the revised ISA 700 is prepared annually as part of the audit approach and tailored to the specific circumstances of the company, and thus the likelihood of ‘boiler plate’—standardized reports that are recycled without much change—is reduced.
- 3.463 In addition, as the new requirements of ISA 700 are framed in relatively high level terms, there is opportunity for firms to differentiate themselves based on the quality of reporting to shareholders, and to demonstrate quality and innovation. Further, we understand that when the AQR team reviews an engagement audit file it will consider if the audit report is correctly prepared based on information on the audit file (as required by ISA 700). Therefore when ISA 700 is amended, we believe that the AQR team will have a role to consider the quality of the resultant disclosures. Our remedy to require more frequent AQR will ensure that audit reports across the FTSE 350 are reviewed and that issues will be reported both at company, firm and audit industry level (via FRC consolidated annual reporting for the major UK firms).

²⁸⁵ Decreasing the materiality threshold would reduce the tolerable range of accounting estimates and reduce the likelihood of aggressive accounting treatments.

²⁸⁶ This is a requirement of the EC Statutory Audit Directive (2006/43/EC).

3.464 Based on the above points, we consider that the new disclosures required by ISA 700 will be effective in increasing information to companies and shareholders on audit quality, and will thus contribute to increasing company bargaining power and increasing the influence of shareholders in auditor appointment decisions. We are therefore not recommending any measures in respect of the audit report.

Design issues in requiring AC reporting on AQR team findings

3.465 As discussed above, we would expect the AC to have regard to the AQR team's findings in assessing auditor effectiveness and consider that the utility of Audit Committee Reports could be improved by requiring the AC to disclose information about this. Specifically, we propose that ACs be required to report on any AQR undertaken on the audit and completed during the reporting period, the grade achieved and how the AC has used this to assess the effectiveness of the auditor.

3.466 We considered that the AC was better placed to make such disclosures than the FRC or AQR team as they may potentially affect the company's share price (for example, where an AQR grade is poor thus casting doubt on the audit opinion). We consider that there are merits in allowing the AC an opportunity to explain to shareholders what steps it has taken to respond to a poor AQR grade to ensure the effectiveness of external audit.

3.467 We noted that under the Comply or Explain regime the AC may choose not to disclose the grade if it was perceived to harm the commercial interests of the company.²⁸⁷ However, we consider that any failure to disclose on these grounds would be likely to attract considerable attention and investors would infer that that grade was poor.

²⁸⁷ However, if sufficient other companies were to disclose their grades, a third party may be able to identify the grade of the AQR on a company's audit.

Effect of our proposed remedies

3.468 Our remedy to require ACs to report the outcome of AQR is directed to supplying further relevant information to shareholders on the quality of the external audit and on the effectiveness of the AC in discharging its duties to procure a high quality audit in behalf of shareholders. We consider below the impact of requiring ACs to report on the outcome of the most recent AQR.

3.469 The requirement to disclose AQR grades will lead to greater availability of information on audit quality, both on audit firms in general, as well as on individual engagements, and by inference on individual audit teams and partners. This information will assist companies to compare the quality of their own audit with that of other firms, and thereby contribute to addressing the lack of bargaining power that we have provisionally found.

3.470 Disclosure of AQR findings and actions taken by ACs as a result will provide investors with better information with which to assess how effectively the AC has discharged its responsibilities to protect shareholder interests in matters concerning external audit. We expect this to contribute towards ensuring that ACs take account of shareholder demands in managing the relationship with the external auditor and in auditor appointment decisions.

Costs

3.471 We do not believe there will be any direct costs for firms or investors as a result of this remedy.

3.472 We believe that any amendment to the UK Corporate Governance Code will have minimal additional cost to companies in preparing the Audit Committee Report. The AC has an existing requirement to consider the effectiveness of the auditor in

reaching a conclusion on reappointment. For those ACs that are discharging their responsibilities appropriately, we do not perceive there to be a significant cost attached to describing the actions that they have taken in this respect.

3.473 We considered whether or not the requirement for ACs to disclose the grade would affect the costs incurred by the AQR team in determining the grading to apply to a file review. We were concerned that firms might perceive there to be an increase in their litigation risk should an audit be graded as unsatisfactory and as a result challenge the FRC more aggressively, which might cause the FRC to incur more staffing or legal costs in dealing with firms' challenges. Whilst firms are conscious of the reputational impact of having any audit graded as unsatisfactory (and included in the firm's performance by the AQR team in the respective firm-level reports), and thus already have incentives to challenge the AQR team, we consider that disclosure by the AC could enhance those incentives. On balance we consider that the AQR team may need to increase its resources as a result of the additional transparency and scrutiny that this remedy will place on its findings. We have been unable to quantify this additional resource requirement with precision but do consider that it is unlikely to be substantial as the AQR gradings are already subject to considerable challenge by firms. The requirement for ACs to report on the findings of AQR team reviews will provide more information on the conduct of the audit and will help reinforce the importance of audit quality as an element of shareholder demand. We believe there is a wider public benefit to the UK as a result of increased confidence in audit quality and corporate governance. We do not perceive there to be any wider costs.

Implementation

3.474 We recommend that the FRC should require through the UK Corporate Governance Code that: 'In reporting how the AC has assessed the effectiveness of the auditor, the AC should report on whether the AQR team has concluded a review on the audit

of the company's financial statements in the reporting period, what the principal findings were, including grade and how both the AC and auditor are responding to these findings.'

3.475 For the reasons set out in paragraph 3.366 and footnote 248, we do not consider it appropriate to limit the application of this remedy to FTSE 350 companies only but consider it should be a requirement for all premium listed companies applying the UK Corporate Governance Code.

3.476 With respect to the timing of implementation, we provisionally recommend that amendments to the UK Corporate Governance Code be made by 6 April 2014 in line with the timing set out in paragraphs 3.367 to 3.370.

3.477 The CC welcomes views on the proposed remedy and the feasibility of the proposed timing.

Assessment of Remedy 7: Competition objective for the FRC

Summary

We have provisionally decided to recommend that:

- The FRC amends its articles of association to give it a competition objective. The amendment would require the FRC when exercising its existing functions to do so in a way which has due regard to the need for competition in the statutory audit market for FTSE 350 companies.

We consider that this amendment would, as part of the package of other proposed remedies:

- Enable the FRC, both generally and in specific matters, such as the preparation of AQR team reports, to provide a regulatory framework which includes appropriate incentives to encourage quality and innovation in the statutory audit market.
- Enable the FRC to take steps to help FTSE 350 companies assess the quality of audit services being offered, and thereby strengthen these companies' bargaining power outside the tender process. Such steps could include modifying the scope of AQR team investigations and reports to make them focus on a wider range of FTSE 350 companies and statutory auditors.

The proposed amendment would not confer any concurrent powers on the FRC. It would continue to have no power to investigate or enforce the competition rules under the Competition Act 1998 or the Treaty on the Functioning of the European Union.

Introduction

3.478 In this section, we:

- (a) set out background regarding the our provisional findings, the FRC, and audit quality;
- (b) the aims of the remedy;
- (c) parties' views;
- (d) our assessment of effectiveness and costs; and
- (e) conclusion.

Background

3.479 In our Notice of a further possible remedy we considered whether giving the FRC a secondary duty, to carry out its primary duties in a way which, so far as possible,

promoted competition between firms providing audit services to FTSE 250 companies.

3.480 We considered that this would contribute to remedying the AEC we had provisionally found by (a) increasing the transparency of AQR reports, thereby enabling companies and shareholders to assess better the quality of their existing auditor, compared with other options; (b) increasing, in combination with other remedies, a company's bargaining power outside the tender process; and (c) making a company more likely to switch auditors, thereby increasing rivalry.

3.481 Having carefully considered the responses to the Notice of a further possible remedy, we have provisionally decided to modify the proposed remedy to give the FRC a competition objective such that, when exercising its existing functions in relation to audit, it does so in a way which has due regard to the need for competition between the statutory auditors of FTSE 350 companies. The reasons for this are given below (see paragraph 3.520).

The FRC

3.482 The FRC was incorporated in March 1990 as a private company limited by guarantee.²⁸⁸ In recent years the FRC's role has changed and it is now the UK's independent regulator responsible for promoting high-quality corporate governance and reporting in order to foster investment. It has delegated statutory functions which it exercises on behalf of the Secretary of State and non-statutory responsibilities in relation to audit.

3.483 The FRC's articles of association²⁸⁹ set out its corporate objects as follows:

²⁸⁸ Registered in England Company No. 02486368.

²⁸⁹ As last amended by special resolution with effect from 2 July 2012.

- to promote and maintain investor, market and public confidence in the integrity, competence and transparency of corporate governance and corporate reporting systems and in the auditing, accounting and actuarial professions in the United Kingdom;
- to perform and discharge any and all functions and powers delegated to or conferred upon the Company or any part of the Company from time to time pursuant to any statutory provision or any modification or re-enactment thereof;
- without prejudice to the generality of paragraphs (a) and (b) above to carry on, oversee or direct any activity concerned with the following:

Codes and Standards

...Audit Quality

...

- (ix) the independent monitoring of the performance of statutory audit functions by means of inspections

Conduct

...

- to perform any other function incidental to the objects referred to in this Article 3 which in the opinion of the directors of the Company can be conveniently performed in conjunction with and without prejudice to the proper performance or discharge of any of the said objects.

3.484 Thus, two main objects of the FRC are:

- (1) to promote and maintain investor, market and public confidence in:
 - (a) the integrity, competence and transparency of corporate governance and corporate reporting systems; and

(b) the auditing, accounting and actuarial professions in the United Kingdom; and
(2) to perform and discharge any and all functions and powers delegated to or conferred upon the Company.

3.485 The FRC also has a specific power to act in relation to Codes and Standards, including the monitoring and inspection of statutory audit functions, and to perform other functions which are incidental to its other objects.

3.486 The FRC conducts a number of inspection reviews of statutory audits each year. These reviews, the FRC point out, 'focus on how a particular audit was performed and are not designed to assess whether the information being audited was correctly reported'.²⁹⁰ In our provisional findings we provisionally found that it was difficult to identify an objective external metric to allow reliable comparisons of quality between audits, but that the AQR team reports published by the FRC are an important independent external source of information on the quality of statutory audits of large companies.²⁹¹

3.487 At present these AQR team reports are designed to promote audit quality by identifying matters in the audits under review that caused the AQR team particular concern, so that any lessons learned are able to be considered by all firms, and thereafter reflected in the procedures and staff training of all firms where appropriate.

3.488 Confidential AQR reports, which focus on issues arising from review of particular audit engagements, are now²⁹² sent to the audit committee or directors of the audited entity, as well as to the relevant audit firm and the professional accounting bodies.

²⁹⁰ AQR Annual Inspection Report 2012/13, p6.

²⁹¹ Provisional findings, paragraph 11.

²⁹² As from 1 April 2013.

3.489 Public AQR reports on inspections carried out on each major audit firm (at present these are the Big 4 firms plus five others) are published on the FRC's website. This individual report shows for each major firm: the total number of audits reviewed, and the number of these audits which fell into one of three categories: (i) good with limited improvements required; (ii) acceptable but with improvements required; and (iii) significant improvements required.²⁹³

3.490 In addition, the reports provide a list of key findings and areas to which the firm in question should pay particular attention.

3.491 As the selection of audits to inspect is based on an assessment by the FRC of size and risk, inspections of audits carried out by the Big 4 firms are more frequent than inspections of the other five firms.

Aims of the remedy

3.492 Our view is that competition is not only a driver of lower cost and greater efficiency, but is also a driver of enhanced quality and of increased variety and innovation in the goods and services being offered.

3.493 Our Guidelines state that 'Competition is a process of rivalry as firms seek to win customers' business. It creates incentives for firms to meet the existing and future needs of customers as effectively and efficiently as possible—by ... improving quality or variety, or introducing new and better products, often through innovation'.²⁹⁴

3.494 We think that there is scope for the FRC, as the regulator most closely concerned with audit and corporate governance, to have due regard to the need for competition between firms which provide statutory audit services to FTSE 350 companies.

²⁹³ Provisional findings, paragraph 7.105.

²⁹⁴ CC3 (Revised), paragraph 10.

- 3.495 However, the lack of a specific corporate objective covering such action is likely, in our view, to constrain the FRC when exercising its primary functions as regards audit, from having due regard to competition.
- 3.496 Our aim in giving the FRC a competition objective would be to give the FRC a firmer base on which to take appropriate action to address the ‘muted forces’ of competition we have provisionally found to exist in the market for supply of statutory audits services to FTSE 350 companies.
- 3.497 We consider that one specific example of how the FRC could use a new competition objective would be in the way it produces its AQR team reports. The FRC is the only independent external source of information that we have identified on the quality of statutory audits of large companies, so it is well-placed to address the AEC that we have provisionally found.
- 3.498 At present the FRC’s AQR team reports promote audit quality by focusing its inspections on the audits which the FRC considers to be the most complex and risky (see paragraph 3.492 above). The inspections are mostly of audits conducted by the Big Four, but the reports are published in a way intended to ensure that all audit firms are aware of particular matters that caused the AQR team concern, so that any lessons to be learned can be considered by all firms, and reflected in their procedures and staff training where appropriate.
- 3.499 However, an alternative approach might be to inspect the audits of a wider range of FTSE 350 companies—ie a selection not limited to those judged to be the most complex and risky, but including inspections of companies which may be considered typical of the FTSE 250 rather than the FTSE 100. Such an approach would still focus on the quality and innovative aspects of the audits, but may enable the FRC to

make such reports capable of being used by companies and ACCs to make some comparisons between rival audit firms.

3.500 We consider that if this could be achieved, and competition between statutory auditors was intensified, it would provide an incentive for such firms to offer audits of higher quality and greater innovation (as these would be the aspects of the audit on which the reports would focus).

Views of parties

3.501 In our Notice on a Further Remedy we sought views on whether to recommend that the FRC had a secondary duty, to carry out its primary duties in a way which, so far as possible, promoted competition between firms providing audit services to FTSE 250 companies.

Regulatory Bodies

- *The FRC*

3.502 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.

3.503 On the specific question of whether AQR team 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 audit committees and investors in relation to changing auditors in addition to improving quality. However, it had concerns about the cost implications, as the FRC considered that it would need to carry out about six times the number of inspections it carries 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 the AQR team of individual audits.²⁹⁵

- *The OFT*

3.504 The Office of Fair Trading (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.’

3.505 The caution derived from a risk of ‘the remedy contributing towards a possible proliferation of bodies with a competition remit, which might suggest that 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 jeopardised if the FRC felt that they would have to be written in a way that actively promoted competition’.

- *ICAEW*

3.506 The ICAEW ‘in principle endorsed the proposal as set out in the Notice’. However the ICAEW did ‘not wish to see the AQR [team] instructed to consider the promotion of competition as part of their remit. Their focus should be solely on audit quality’.

- *The audit firms*

3.507 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 should be effective.

²⁹⁵ [FRC response to Notice of a further possible remedy.](#)

- 3.508 KPMG said that it was not clear what change or benefit this remedy option would bring and considered that it might distort outcomes in the market. 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 on an assessment tailored to the needs of the particular company and this is best done by ACs.
- 3.509 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.
- 3.510 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 AQR [team] reports are performed and reported’.
- 3.511 GT considered that one way of improving the ability for companies and investors to compare audit firms was to increase the regularity of AQR team reviews on audit firms which were not among the four largest firms and there should be an identical frequency of publishing reports for all nine major firms.
- 3.512 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.
- 3.513 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 and 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 team were drawn from Big Four backgrounds. Kingston Smith recommended that the serving members of the FRC and its various bodies needed to be drawn not just from the largest firms.

3.514 Mazars too 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'.

Other bodies

3.515 The National Association of Pension Funds Limited 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.

3.516 Governance for Owners LLP sent a letter, signed also by Fund and Asset Management firms, which did not oppose the proposed remedy, so long as it was not used as the sole remedy. However, it did not understand how the remedy might lead to further switching.

3.517 The GC 100 Group did not consider it appropriate to give the FRC a secondary duty to promote competition between firms providing audits to FTSE 350 companies.

3.518 Further details of the views of parties on giving the FRC a competition duty are set out in Appendix 3.8.

Assessment of effectiveness

- 3.519 The responses from interested parties suggest that most considered that this proposed additional remedy had some merit, although they treated specific applications of such an additional secondary power with some caution. Only KPMG considered the proposal had no merit.
- 3.520 However, some parties—in particular, the FRC—had concerns about the resource implications of the FRC having a separate, albeit secondary, duty to promote competition. They considered that it might be necessary for the FRC to strengthen its resources by recruiting additional staff with competition experience and expertise, in order to perform such a secondary duty effectively.
- 3.521 Having considered carefully the responses that we received, we have provisionally decided that it may be sufficient if the FRC has an objective, when carrying out its primary functions as to statutory audits, to have due regard to the needs of competition between audit firms offering statutory audit services to FTSE 350 companies.
- 3.522 We see this remedy as forming part of a package of remedies, rather than forming a ‘stand-alone’ remedy. However, as an addition to the FRC’s other aims and powers, it would underpin and reinforce the steps the FRC is already taking (eg its revision to the Code) to make the statutory audit market for large companies work better.
- 3.523 We do not envisage that this remedy would cause the FRC to incur significant additional costs.

Conclusion

3.524 We consider that this proposed remedy to give the FRC a competition objective is not a self-standing remedy, but one which forms part of the package of remedies intended to address the AEC we have provisionally identified in our provisional findings report.

3.525 We consider that having such an objective will enable the FRC to take other steps, such as modifying its AQR team reports, as discussed above, which will help remedy the AEC we have provisionally identified, and that it is a cost-effective and worthwhile addition to the FRC's objectives.

4. Remedies we are not minded to pursue

Introduction

4.1 In the Remedies Notice we suggested that FTSE 350 companies may be required after a specified period of time to switch auditors to address the AEC that we provisionally found arose under our second theory of harm. Our provisional view is that we should not pursue such a remedy, and set out our reasons in paragraphs 4.4 to 4.66.

4.2 We also identified a number of possible remedies which we considered to be ineffective or disproportionate in addressing the provisional AEC. These remedies were:

(a) constraining NAS provision by the auditor (see paragraphs 4.67 to 4.89);

(b) joint or major component audit (see paragraphs 4.90 to 4.112);

(c) shareholder group responsibility for auditor reappointment (see paragraphs 4.113 to 4.129);

(d) FRC responsibility for auditor appointment (see paragraphs 4.131 to 4.141); and

(e) independently resourced Risk and Audit Committee (see paragraphs 4.142 to 4.152).

4.3 The responses were largely focused on (a) constraining NAS provision and (b) joint or component audit. We received relatively few comments on the other remedies (c) to (e). We believe that this tends to support our rationale for not pursuing these remedies as set out in the Remedies Notice.

Mandatory switching

4.4 In the Remedies Notice we said that the optimal time frame for mandatory switching would be based on a judgement which weighed up the benefits of a new firm providing a fresh approach against the potential costs of switching from a firm that

has built up experience of auditing the particular company. We specifically asked for views on switching periods of seven, ten and 14 years.

4.5 It is our provisional view that we should not pursue such a remedy. We have come to this view since we think that there are other remedies that would effectively address the AEC identified in our provisional findings and that the incremental gains from mandatory switching would therefore be unlikely to outweigh the costs. This section is structured as follows:

(a) Aim of the remedy.

(b) Approach.

(c) Views of the parties.

(d) Assessment of effects.

Aim of the remedy

4.6 We consider that mandatory switching could contribute to addressing the AEC, first, by dealing directly with concerns expressed by some investors that the independence, objectivity and scepticism of the auditor may be compromised where an audit firm has retained an engagement for many years, and, second, by providing the benefit of a fresh approach to the audit of a company. We consider that the regular switching of auditor might, as a result, increase the trust investors have in the audit opinion.

4.7 We also consider that more frequent switching might have the benefit of reducing switching costs, actual and/or perceived (we think some companies consider that the costs of switching auditors are more onerous than they really are), and thereby increase the bargaining position of companies by increasing their willingness to switch (see paragraphs 4.41 and 4.42).

4.8 We consider that the experience gained from more frequent switching would be shared with other companies, as a result, for example, of ACCs holding positions on ACs or boards of other companies or through other networks of contacts. As a result, companies may learn from the experience of others and judge that they are better able to manage the transition process. This sharing of experience may also help to dispel some of the fears that there appear to be on the costs associated with switching auditor.

Approach

4.9 We consider the aims of mandatory switching are similar to those of Remedy 1 (mandatory tendering, see paragraphs 3.9 to 3.19). In particular, we consider that Remedy 1 (a requirement to tender every five years) in combination with other remedies that we are proposing, in particular Remedy 5 (strengthened accountability of the external auditor to the AC), may be expected to give ACs, as representatives of the interests of shareholders, more influence in the appointment of the auditors. We expect Remedy 1 to result in more switching in circumstances where this is judged by those involved in the selection process to be in the best interests of the company and its shareholders.

4.10 However, we recognize that a key effect of mandatory switching would be to exclude the incumbent from the competition for the engagement once its term expires and that there would be a further loss of efficiency if the incumbent would have been the preferred bidder at that point. We consider that this could limit the effectiveness of the remedy, although the impact on competition might be lessened if the remedy created incentives for firms to invest in the capabilities required to be credible bidders for engagements which at present they have little chance of winning.

- 4.11 Mandatory switching might be considered necessary if there was an expectation that mandatory tendering would be ineffective or not fully effective. A possible formulation would be to require mandatory tendering (as in Remedy 1) after a number of years, but if the same firm were retained there would be a back-stop date by which time the firm had to be rotated, for example, after two tender periods. Mandatory tendering and switching could thus be complementary means of addressing the AEC identified in the provisional findings.
- 4.12 Our approach to the assessment of this possible remedy has therefore been to consider the costs and benefits incremental to those of the proposed package of remedies.
- 4.13 The EU is considering reform to the statutory audit market and in particular mandatory switching and restrictions to NAS. However, the debate and legislative process continues within the EU, and so we have not factored in prospective EU changes directly.

Views of parties

- 4.14 In this section we summarize the views of interested parties, namely: the investment community; FTSE 350 companies; Big 4 and Mid Tier audit firms; the FRC; and academics. The views are set out in detail in Appendix 4.1.

Investors

- 4.15 The views of the investors were mixed: some were strongly opposed to mandatory switching and others supported switching every 10 to 15 years.
- 4.16 Those opposed to mandatory switching were concerned that this would undermine the accountability of the auditor to the AC. There was also thought to be a risk of

significant disruption to the audit process and a reduction of overall audit quality given the loss of institutional knowledge. Audit risk was said to be highest during the first few years of an engagement. They also said that choice of auditor would be for some companies limited possibly to one alternative.

- 4.17 One investor supported mandatory switching every ten years and several supported switching every 15 years. This was said to be an effective and proportionate response to the misaligned incentives facing auditors. One investor said that the trust that could be had in audits depended on the independence of the auditor, real and perceived, and that it was difficult for shareholders to ascertain whether auditors were independent as the boiler-plated audit opinions shed little light on the discussions that took place between audit partners, company management and ACs. Another said that long tenure could materially impact on auditor independence and objectivity. A 'fresh pair of eyes' was said to introduce a check on incumbent audit firms' work, and ensured the audit was not unduly influenced by historical judgments as well as the client's management. Mandatory tendering was also said to remove negative market signals associated with changing auditor. One investor said that the higher costs would be worth paying for greater market confidence in the degree of scrutiny applied to audits

FRC

- 4.18 The FRC opposed mandatory switching because it would reduce choice and might 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.

4.19 The FRC said that there was also a risk that mandatory switching would effectively undermine the authority of the AC operating in the best interests of investors by taking the question of reappointment out of its hands. The FRC said that would be inconsistent with the CC's views on the role and accountability of the AC.

4.20 The FRC said the prospects of switching 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, switching could therefore lead to a danger of a company having no effective choice.

FTSE 350 companies

- *Responses to the Remedies Notice*

4.21 All the FTSE 350 companies that responded to the Remedies Notice opposed mandatory switching. They said that this would be highly disruptive and could compromise audit quality. Some said that the risks associated with mandatory switching would be likely to outweigh the benefits. The reasons given for these responses included: it would take time for a new auditor team to fully understand the business; a new auditor that was less familiar with the business would be less able to provide a robust challenge to management; the balance between the benefits of continuity and renewed challenge were appropriately met by the requirement for partner switching; 'educating' the new auditor would be a significant burden on management; the options for switching were limited by the impact of other NAS received by the company from other providers; and the switching of auditors would have a knock-on effect of requiring switching of these other services.

4.22 They said that mandatory switching could force companies to change auditor at a time when the existing auditor's understanding of the business would benefit the

audit process. The AC was said to be best placed to decide whether the company should go out to tender/switch auditor. 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. One company said that auditor appointment should be maintained at the discretion of shareholders. The perceived benefits of 'continuity' were said not to undermine the company's ability to go out to tender and/or switch if appropriate to protect shareholders' interests.

- *Case studies*

- 4.23 There was little support for mandatory switching of audit firms among case study companies. It was said that the result would be less choice as the incumbent would have to be excluded. The FD of Company S said that mandatory switching would have left Company S with the choice of only one firm. However, two interviewees considered that mandatory switching would be acceptable if the period of time was reasonable and one thought that ten years would be acceptable.
- 4.24 Switching was said to have the benefit of a fresh and independent perspective and assessment. The GFD of Company T said that he had gained additional insights as a result of switching auditor. There was said to be a degree of risk associated with a 'fresh pair of eyes' that the new auditor might disagree with its predecessor's assessments, but that this risk could be seen as a benefit.
- 4.25 Some companies said that these benefits had to be weighed against the risk that the incoming firm would not know as much about a company as its predecessor, would be less able to ask probing questioning and could fail to spot an important auditing issue. Sector experience was said to help to some extent with this but the first year of a new audit team's incumbency was difficult. Estimates of the costs to the company of getting the new auditor up to speed varied. The ACC of Company T said he had to

spend twice as much time on Company T's business when the new auditor was first appointed than he spent during a normal year (although he regarded this as time well spent) whereas the ACC of Company W said he spent only a few additional hours on top of the 50 to 60 days he normally devoted to his ACC work.

Big 4 firms

- 4.26 The Big 4 firms said that mandatory switching:
- (a) would not address the AEC and would be less effective than mandatory tendering. They said that we had not provided evidence in the provisional findings that length of tenure had an impact on independence, or that the current system of AEP switching every five years was insufficient;
 - (b) would restrict or distort competition by restricting choice;
 - (c) could undermine good corporate governance as companies and their shareholders should be able to appoint the audit firm and partner best placed to meet their needs;
 - (d) would force companies to incur substantial switching costs associated with appointing a new audit firm and result in the loss of knowledge and understanding of a company that could enhance professional scepticism and audit quality;
 - (e) could interrupt the provision of NAS and reduce the likelihood of companies buying NAS from firms that also provided audit services and/or audit firms in bidding for non-audit work, resulting in a reduction in competition in the provision of NAS; and
 - (f) would dampen competitive pressure outside of the prescribed windows for switching.
- 4.27 KPMG estimated the costs to audit firms of gaining an understanding of a business in the first year of an audit to be 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.

- 4.28 KPMG also estimated part of the costs associated with mandatory switching at £54 million or £46 million respectively if the remedy was implemented on a 10- or 14-year basis, and the cost associated with increasing FTSE 350 companies' cost of capital to be in the region of £1 billion. The substantial burden associated with resolving NAS independence issues and international coordination would be additional to these costs.

Mid Tier firms

- 4.29 BDO said that academic studies had concluded that mandatory switching was detrimental to audit quality and increased concentration in the audit market (as clients of Mid Tier firms rotated away from them to the Big 4). BDO recognized that there was pressure for switching from some investors, but said that mandatory tendering was preferable. BDO said that mandatory switching denied companies the right to make an informed choice to retain their present auditor, and could force a company to change auditor despite having little choice.
- 4.30 Kingston Smith did not agree that mandatory switching would reduce barriers to involvement on non-Big-4 firms in the market, and said that 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.
- 4.31 GT supported mandatory switching after 15 years as a measure to prevent complacency. GT said that while the current requirement for AEP rotation was an important safeguard, it did not address the perceived loss of independence when the audit firm was in place too long. It said 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. GT said that 15-year switching 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 arose. GT considered that the costs of the remedy would be minimal and likely to be overstated by those who opposed their introduction.

4.32 GT considered that limited choice was to a degree self-inflicted, in that the company chose to award NAS to a potential alternative auditor when other firms would almost certainly have the capabilities to provide those NAS.

4.33 Mazars supported a mandatory switching period of 15 years, subject to derogation or significant extension in the event a company appointed joint or major component auditors. Mazars believed that the benefits would outweigh the costs of 'educating' a new firm and the additional costs to the firm in the first year of a new audit if tendering were linked to joint and major component audit.

4.34 Crowe Clark Whitehall (CCW) supported mandatory switching at 20 years.

Academic literature

4.35 Professor Doctor Köhler said that the barriers to switching suppliers of audit services were caused by transaction costs on the demand and supply side and the nature of the service (ie experience good). Given these market characteristics, all other things equal, long audit tenure was therefore an efficient market solution. Professor Köhler said that empirical evidence was mixed on the relationship between tenure and audit quality, 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. She added that there might even be a potential decline in audit quality.

- 4.36 Professor Doctor Köhler also said that 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. She said that in Germany there was clear empirical evidence that (voluntary) auditor change resulted in increased concentration with a shift of market share from non-Big-4 to Big 4 audit firms.
- 4.37 EY said that research suggested that mandatory firm switching 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.
- 4.38 KPMG said that Arruñada and Paz-Ares (1997) found that mandatory firm switching led to an increase in audit fees of between 4 and 15 per cent just because of increased in costs, and that these could be higher if there was also a reduction in competition.
- 4.39 KPMG said that it was well-established in the academic literature that companies' governance standards affected their cost of capital. Most recently, Chen, Chen and Wei (2009) showed that good governance was associated with a lower equity cost of capital, and Bhorraj and Sengupta (2003) showed that there was a cost of debt effect. KPMG said that Lambert, Leuz and Verrecchia (2007) found that increasing the quality of mandated disclosures should generally reduce the cost of capital for each firm in the economy.

Assessment of effects

4.40 As explained above, in the assessment we consider how the benefits of a possible remedy of mandatory switching might compare with those the proposed package of remedies might be expected to deliver. We then consider the costs and risks associated with requiring companies to switch auditor after a specified period. We draw principally on the evidence provided by provisional findings, submissions made in response to the Remedies Notice, the remedies hearings, and further case studies conducted with ACCs and FDs.

Incremental benefits of mandatory switching

4.41 As explained above, we consider that the potential benefits associated with mandatory switching would be: that investors could place more trust in the assurance provided by the audit report to the extent that any mistrust is based on the long tenure of engagements; a reduction in the costs of switching auditor (actual and/or perceived) resulting in a greater willingness to consider switching auditor outside the prescribed window; and increased incentives for Big 4 and Mid Tier firms to invest in expanding their capabilities in order to compete for engagements that they can confidently predict will become vacant on a certain date.

4.42 We also consider that the proposed package effectively implemented could be expected to promote the trust that investors can place in audit outputs. In particular we would expect the proposed package of remedies to deliver the following benefits:

- (a) To result in more switching in circumstances where this is judged by those involved in the selection process to be in the best interests of the company and its shareholders (see paragraph 3.50).
- (b) To give shareholders greater confidence in the audit outputs by giving ACs, as representatives of the interests of shareholders, greater responsibility in the selection of the auditor, making it clear that auditors are accountable to the AC,

and ensuring that ACs are actively involved in the management of the audit engagement (see Remedy 1 and Remedy 5).

(c) To provide investors with more information than is currently available to them, and would be provided by the FRC's enhanced reporting requirements, putting them in a better position to judge for themselves whether the auditor is acting in their interests (see Remedy 6).

4.43 We consider below in more detail the extent to which mandatory switching could be expected to deliver benefits over and above those that would be expected with effective implementation of the proposed remedies package.

- *Investor trust in the audit opinion*

4.44 In response to the Remedies Notice, a number of investors expressed concerns about trust they can have in an audit when the same auditor has audited a company's financial statements for many years. The trust that investors can place in the audit opinion was said to depend on the independence and objectivity of the auditor, real and perceived.

4.45 We note that the concerns expressed by investors are not limited to those arising from a perception that over time a relationship might develop between auditor and client in which the auditor does not question or challenge management as much as it might have done in the past. There also appears to be a concern that after a while the current auditor might be less likely to challenge its own judgements, ie the judgements made in conducting the audit in previous years. It is hard for a firm to revise or reverse a judgement that it has applied over a number of years.

4.46 Investors also said that it was difficult for shareholders to ascertain whether auditors were independent as the boiler-plated audit opinion and report shed little light on the

discussions that took place between audit partners, company management, and ACs.

4.47 With the proposed package of remedies ACs will be accountable to shareholders on the appointment and work of the auditor, the auditor will be directly accountable to the AC and shareholders will have more information to judge for themselves the quality of the work undertaken by the auditor. We therefore consider that the proposed remedies package effectively implemented would allow investors to place greater confidence in the quality of the audit opinion.

- *A ‘fresh pair of eyes’*

4.48 In the recent case studies, FDs and ACCs said that the benefits of switching were a fresh and independent perspective and assessment (see paragraph 4.24). We agree that the benefits of requiring a company to switch auditor after a specified period would be to restart the relationship. The expectation would be that to conduct the audit a new auditor would have to ask probing questions in order to become sufficiently informed to form an opinion and in so doing challenge management. The new auditor would also have no attachment to the audit opinions of the previous audit firm. We have been told that a new auditor could not place any reliance on previous audit approaches or judgements.²⁹⁶

4.49 With the proposed remedies package we would expect companies to switch auditors more often than has been the case in the past. Crucially we would expect companies to switch auditors where the AC determined that this would be in the best interests of the shareholders.

²⁹⁶ We note ISA 510 ‘Initial Audit engagements—Opening Balances’, paragraph 6(c) requires an incoming auditor to establish if the opening balances are materially correct. This can be achieved either through reviewing the previous auditor’s work papers or undertaking additional procedures to assess if they are correct, if the auditor’s audit approach for the reporting period is not sufficient to obtain this assurance. If issues were found in the current reporting period, the auditor would need to consider if this impacted on the previous period’s closing balances.

- *Reduction in switching costs*

- 4.50 In the provisional findings we found that the costs to FTSE 350 companies of switching auditor were material in the context of the bargaining position of these companies in their annual negotiations with their incumbent auditor (see the provisional findings, paragraph 9.259). We recognized that these costs would be higher for some companies than others (in particular those with the more complex audits). Compliance with independence rules was a particular issue for banks.
- 4.51 Our recent case studies showed that the (eight) companies that had switched had generally found the switching process was manageable. At Company K the transition process was less intensive than the CFO had expected and the Group Financial Officer of Company T considered that the process had not added greatly to the usual process of interfacing with the auditors. Other interviewees said that switching costs could be reduced by careful planning. Mr Nick Land said that companies found that switching auditor was less disruptive than expected and that the transition to a new audit firm could be relatively painless.
- 4.52 Mid Tier firms said that our first survey evidence highlighted that those FTSE 350 companies that had switched auditors had not found the process particularly burdensome or the costs particularly high. KPMG and PwC considered that there was no perception gap between actual costs and perceived costs (see the provisional findings, paragraph 9.155). PwC considered that the FDs and ACCs who selected the audit firm could accurately assess the costs involved in switching.
- 4.53 Historical levels of switching suggest that many ACCs and FDs of FTSE 350 companies may not have recent experience of switching auditors. Under a mandatory regime more companies would be switching auditor. As a result of ACCs holding other positions on ACs and boards of other FTSE 350 companies, we would expect

the experience and knowledge gained to be shared with others (see paragraph 4.7). Over time we might therefore expect this sharing of experience to result in companies and firms managing the transition process more efficiently. If switching turned out to be less painless than expected, this experience might lead to others revising their expectations.

4.54 As said above, we would also expect the proposed package of remedies to result in more frequent switching and for there to be the same sharing of this experience, resulting in an increased willingness to switch.

- *Incentives for firms to invest in expanding capabilities*

4.55 We consider that excluding the incumbent from the competition for some engagements would increase the probabilities of rival firms gaining an engagement that they would not otherwise have had. Mid Tier firms have said that companies might actively encourage rival firms to position themselves to be able to compete for the audit engagement.

4.56 In summary we consider that mandatory switching would be expected to result in FTSE 350 companies switching auditors more often than would be the case with implementation of our proposed remedies package. How much more is unclear at this stage. However, compared with the proposed package of remedies, the benefits gained would be associated with switches in auditor that would not have been judged by the AC to be in the best interests of shareholders.

Costs associated with mandatory switching

4.57 We consider that to require companies to switch auditors after a specified period could impose costs on the companies and investors. In particular:

- (a) the costs resulting from exclusion of the incumbent from the competition for the audit. These might be mitigated by the incentives created by the remedy for non-incumbent firms to invest in their capabilities;
- (b) the costs to the company and firm associated with switching. In particular: the loss to the company of the 'continuity' benefits and the incumbent firm's 'client-specific' investment in the audit engagement; the costs to the company in educating a new auditor; and the costs for firms and companies related to resolving independence matters including the implications a change in auditor may have for the provision of NAS; and
- (c) the adverse effect on the incentives of the incumbent to perform well as the limit on its tenure approaches.

Effect of excluding the incumbent from competition

- 4.58 We consider that excluding the incumbent from the tender process could have two adverse effects on the competition for an audit engagement. First the company may be prevented from reappointing the auditor it considered best placed to be its auditor; and second, even if not the preferred provider, excluding the incumbent could reduce the strength of the competition for the engagement. The evidence on the availability of alternative auditors is relevant to both effects.
- 4.59 We consider that to exclude the incumbent from competition for an engagement, regardless of whether it would have won, has the potential to weaken the competition for the engagement. In any competition, the winner must do enough to beat the second best candidate. Accordingly, if the incumbent is either the best candidate or the second best candidate, its exclusion from a tender process would adversely affect competition.

- 4.60 We found in the provisional findings that in many sectors one or more firms may be at a competitive disadvantage given the importance to companies of relevant experience, knowledge and expertise in the selection of auditors (see the provisional findings, paragraph 9.56). We consider that excluding the incumbent from the competition from the engagement could in many sectors therefore have a substantial effect on the strength of competition and result in the appointment of an auditor that was less well placed to carry out the audit than the incumbent.
- 4.61 In the provisional findings we also considered whether choice might be limited by regulations to prevent loss of independence rules and potential conflicts of interests.²⁹⁷ We accepted that often such situations would be manageable given some notice (see the provisional findings, paragraph 9.48). The recent case studies suggested that choice had been limited by independence requirements in recent tender processes. For example, where a firm was providing a company with non-audit related services (possibly a long-term project) and it would not be in the company's interest to disrupt these arrangements. However, we consider that if required to switch auditors after a specified period, companies would have the time and the incentive to manage the procurement of such services so as to minimize the effect on the procurement of audit and other services.

Switching costs

- 4.62 In the provisional findings we set out our findings in relation to the costs associated with switching auditor (see paragraphs 9.173 and 9.174). At the time, some of the Big 4 firms challenged us on the significance of these costs (see the provisional findings, paragraph 9.154). The recent responses to the Remedies Notice suggest that all the Big 4 firms agree that switching costs may be substantial (see Appendix

²⁹⁷ Specifically Ethical Standards issued by the FRC in the UK, and SEC regulations as a result of Sarbanes-Oxley in the USA.

4.1). GT suggested that those opposed to mandatory switching might have overstated the costs of switching (see Appendix 4.1).

4.63 Those investors opposed to mandatory switching were concerned that this would undermine the accountability of the auditor to the AC. There was also thought to be a risk of significant disruption of the audit process and a reduction of overall audit quality given the loss of institutional knowledge. Audit risk was said to be highest during the first few years of an engagement (see paragraph 4.16).

4.64 Our position remains that there are significant costs for companies and firms associated with switching and that for some companies these costs may be substantial (for example, where the audit is more complex).

Effect on incumbent incentives

4.65 In the provisional findings we considered the evidence on the incentives faced by firms to retain engagements. We found that firms may incur significant costs if they lose a client. We said that firms would lose the income stream of the engagement; their portfolio of engagements in any given sector is weakened (although the extent to which this matters will depend on the strength of the retained portfolio); and they may suffer reputational damage depending on the circumstances of the loss (see the provisional findings, paragraph 9.215). We also said that targeting and obtaining replacement engagements may be expensive: invitations to tender are infrequent, and if successful, the firm must incur the costs in becoming expert regarding that company's business. We consider that there is a risk that as a firms' tenure approaches the maximum allowed, these incentives would be weakened.

Conclusions

4.66 We therefore conclude that while mandatory switching would address concerns expressed by investors where a company has had the same auditor for many years, we consider that the proposed remedies package would be expected to address the AEC more effectively whilst delivering similar benefits and avoiding some of the costs associated with mandatory switching, and in particular the significant weakening of competition that would result if the incumbent were systematically excluded from tender processes. Compared with the proposed package of remedies, the benefits gained from requiring companies to switch auditor after a specified period would be associated with switches in auditor that would not have been judged by the AC to be in the best interests of shareholders.

Constraints on provision of NAS

4.67 In this subsection we:

- (a) note the original discussion of the remedy in the Remedies Notice;
- (b) outline the relevant responses to the Remedies Notice;
- (c) consider if the remedies would be effective in addressing the AEC; and
- (d) make an overall assessment of the effect of the remedy.

Remedies Notice

4.68 In the Remedies Notice, we identified that further constraints on NAS provided by the auditor could potentially increase the independence of auditors.

4.69 We considered two options for increasing independence by restricting NAS provision. These were (a) prohibiting the external auditor from supplying all but audit-related work; or (b) recognizing existing restrictions on the supply of NAS by external auditors and seeking to tighten these existing regulations by, for example, introducing

a limitation on non-audit fee income that may be earned by the auditor as a percentage of the audit fee.

- 4.70 If audit firms have substantial levels of non-audit work with the same client then, in principle, the prospective loss of such non-audit work could be a possible factor which would impair the independence of auditors. This may be a particular problem where the executive management are in a position to offer or withhold non-audit work to auditors.
- 4.71 The potential conflict of interest in external auditors providing NAS is recognized in corporate governance measures, including the role of the AC, and in professional guidelines. We noted in our case studies that there was significant sensitivity to these issues on the part of companies. We noted that different companies had different views as to what type of, and how much, non-audit work could be carried out by the auditor. Currently there is flexibility in the regulations which allows differences in approach whilst recognizing the potential of large non-audit engagements to impair the independent perspective of auditors.
- 4.72 In our investigation we found that audit was profitable in its own right and generated comparable margins to other NAS provided by audit firms. We saw no evidence to suggest that audit was a 'loss leader' whose viability was dependent on obtaining non-audit work.
- 4.73 We also found in the course of our investigation that providing NAS was a key means by which non-incumbent audit firms could demonstrate service quality, sector expertise and capabilities,²⁹⁸ and build relationships with company management. In our provisional findings we identified that company bargaining power could be

²⁹⁸ Provisional findings, paragraphs 9.114(b) & 9.133.

improved through obtaining knowledge about other suppliers.²⁹⁹ Prohibition on providing NAS (as opposed to limiting the level of such services) may therefore undermine a means of facilitating switching from incumbent auditors.

- 4.74 We said in our Remedies Notice that whilst we recognized the potential for the provision of NAS to impair the independence of audit, we considered that in the light of our findings to date and existing controls on NAS provision, we are not currently minded to consider significant additional restrictions in this area.

Responses to the Remedies Notice

- 4.75 Several categories of parties expressed disappointment that we were not considering further restrictions on the provision of NAS by the auditor including Mid Tier firms, investors and investor groups and some representatives of companies; a further argument was made around the danger of multiple firms being conflicted out of an audit engagement should a company choose to award NAS to multiple prospective audit firms. Details of the parties' views on the restriction on NAS are set out in Appendix 4.2;
- 4.76 There were four main themes in the points raised by those parties which supported further regulation of NAS: encouragement of greater focus on the audit, independence and reputational issues, increased exposure of companies to the Mid Tier, and an effective restriction on switching auditors. We summarize these points in turn.
- 4.77 Encouragement of greater focus on the audit: some parties believed that NAS was a distraction to auditors with some perceiving NAS to be more financially lucrative than

²⁹⁹ We discuss the importance of NAS in informing companies of potential suppliers in our provisional findings, paragraphs 9.109, 9.113, and 9.118–120. In paragraphs 9.258–9.260, we note that an inability to assess suppliers weakens companies' positions.

audit (either more profitable, or the relative scale of the potential revenues) leading to auditors focusing efforts on winning additional work.

- 4.78 Independence and reputational issues: some parties believed that the scale of NAS provision threatened auditor independence and the increased level of contact increased the risk of over familiarity with client management. Some parties identified the issue to be a perceived loss of independence.
- 4.79 Increased exposure of companies to the Mid Tier: some parties believed that prohibiting auditors from performing NAS would increase the value of work available to other firms and would necessarily increase the number of firms that companies had knowledge and experience of which might be a factor in deciding which firms to invite to tender for the audit engagement in future.
- 4.80 Effective restriction on switching auditors: some parties noted that the issue of independence around NAS could be a wider issue as any firm undertaking NAS might be prevented from acting as a company's auditor. Some parties thought that the sharing of NAS across Big 4 firms would therefore effectively restrict a company's choice if ACs were not encouraged to consider a wider range of firms.
- 4.81 The Big 4 firms agreed with our provisional view with respect to not pursuing any additional restrictions on NAS.

Consideration of effectiveness in dealing with AEC

- 4.82 We now consider the effectiveness of this remedy option in addressing the AEC that we have provisionally found. We note that the supply of NAS to audit clients is subject to the requirement for auditors to comply with Ethical Standards issued by the

FRC. Ethical Standard 5³⁰⁰ (ES5) identifies types of NAS which may create threats to an auditor's objectivity and the existence of ES5 indicates that post-Enron there were concerns around the impact that providing NAS to an audited entity could have on an auditor's independence and objectivity in supplying audit services.

4.83 In the course of our review, we found that the levels of NAS supplied by the incumbent audit firms to FTSE 350 companies had reduced by 17 per cent³⁰¹ and we did not find a relationship between the value of NAS provided to audit clients and the profitability of audit engagements.³⁰² We were not able to investigate directly whether auditor independence was affected by NAS provision, but, to the extent that independence may be related to audit fee, our evidence did not indicate that this was the case.

4.84 One aspect of our AEC that we provisionally found was that demand was distorted towards the demands of executive management and away from shareholders.³⁰³ We consider that if the award of NAS is influenced by executive management, it may be a factor contributing to the distortion of demand. However, we regard it as a secondary factor that acts in combination with the FD's de facto responsibility for the negotiation of audit fees, appointment and replacement of auditors, and conduct of a company's relationship with its auditors in general.

4.85 We consider that the distortion of demand that we provisionally found under our second theory of harm is addressed by other elements of our remedy package, in particular the stipulation that only the AC shall negotiate audit fees and award NAS contracts to the external audit firm, and other remedies to promote communication with shareholders. We consider that these remedies will increase the influence of the

³⁰⁰ APB Ethical Standard 5 (Revised), Non-audit services provided to audited entities, December 2011.

³⁰¹ Provisional findings, Appendix 20 ('Bundling of audit and non-audit services'), Table 2.

³⁰² *ibid*, paragraphs 34-44.

³⁰³ Provisional findings, paragraph 31(d).

AC in the decision to award non audit services to auditors and may be expected, given the responsibility of the AC to protect independence and scepticism, to further reduce the levels of NAS purchased from companies' external auditors.

- 4.86 Given the above, we did not think that further restricting NAS by auditors would further contribute to remedying the AEC, taking into account the other measures we are proposing to put in place.
- 4.87 We did, however, receive opinions from companies such as the ACC of Company G 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,³⁰⁴ we agree that developing business relationships with a wider range of firms would lead to greater awareness of other audit market participants.
- 4.88 We considered the effects of NAS on firms' incentives to compete in tenders for audit work. In reaching our provisional findings we were given evidence that firms would not decline to participate in a tender process even if winning the engagement would mean the loss of NAS work.³⁰⁵ However, in consulting on our possible remedies we identified a number of examples of firms declining to participate or agreeing with companies not to participate in tender processes because they were undertaking NAS.³⁰⁶ There is a risk that if greater restrictions were placed NAS provision by the external auditor, other firms would necessarily undertake more NAS and might be

³⁰⁴ [Case Study G](#) paragraph 14.

³⁰⁵ Provisional findings, paragraph 9.22.

³⁰⁶ [Case Study W](#) and [Case Study V](#).

disinclined to participate in tender processes thus reducing the level of competition.³⁰⁷

Overall assessment

4.89 We recognize that NAS provision by auditors may be a factor contributing to the distortion of demand that we provisionally found, particularly in circumstances where the award of NAS is controlled by the FD. We consider that other aspects of our remedy package satisfactorily address this issue, in particular our remedy to strengthen the AC which stipulates that only the AC should negotiate NAS provision by the external auditor. Our remedy package addresses the AEC that we have found and we think that further restrictions in this area would not add to its effectiveness; but may add to the costs, particularly in placing further limitations on company choice in respect of NAS provision. Hence we are not minded to consider additional restrictions in this area.

Joint or component audit

4.90 In this subsection we:

- (a) note the original discussion of the remedy in the Remedies Notice;
- (b) outline the relevant responses to the Remedies Notice;
- (c) consider if the remedy would be effective in addressing the AEC; and finally
- (d) make an overall assessment of the impact of the remedy.

Remedies Notice

4.91 We considered a remedy whereby companies would be encouraged to use joint or major component auditors, with the aim of increasing companies' visibility of audit firms' offerings, such that bargaining power was increased. We also considered whether joint or major component audit would address the AEC we have provision-

³⁰⁷ That is not to say that NAS are necessarily more or less lucrative than statutory audit, but delivering certain pieces of work may have specific financial or strategic benefits for a firm.

ally found in regard to distortion of demand, and whether it would be likely to reduce barriers to entry to the reference market.

- 4.92 We considered that encouragement of joint or component audit might be achieved either via a requirement or recommendation for firms to have joint (or major component) audits or in combination with other possible remedy options such as mandatory tendering (or switching). For example, the requirement to go out to tender every X years could be extended to a requirement to go out to tender every X+Y years for those companies with joint or major component auditors.
- 4.93 We noted that to date there had been limited appetite for joint or component audit by companies or institutional investors; and that this did not appear to be driven by the regulations as we found that current regulations did not restrict use of major component auditors. Our evidence suggests that companies regard joint audit as an added complication which may impair accountability for the audit and increase costs.
- 4.94 We considered that the benefits of joint or component audit in giving companies greater visibility of firms' capabilities would be more effectively realized through remedy options such as more frequent tendering and enhanced frequency of AQR team reporting (Remedies 1 and 2).

Responses to the Remedies Notice

- 4.95 The non-Big-4 audit firms strongly promoted shared or joint audits. Their grounds for doing so were equally strongly contested by the Big 4. Investor groups did not challenge the CC's provisional decision not to pursue a remedy in this area.

4.96 Several parties prefaced their views by stating the difference between shared and joint audit. As the European Group of International Accounting Networks and Associations (EGIAN)³⁰⁸ explained:

In the case of joint audits, two or more auditors, usually two, jointly express their opinion on the consolidated financial statements of the group. In the case of consortia [or shared or component]] audits, one firm is responsible for the opinion on the group's consolidated financial statements with one or more other firms participating in the audit of certain subsidiaries.

4.97 The non-Big-4 audit firms advocated a scheme to promote joint and shared audits, either by regulation or by providing incentives. It could, for example, be made mandatory for a company to include at least one non-Big-4 firm in a joint/share audit engagement.³⁰⁹ GT and others suggested that companies might be incentivized to use joint or shared audit via an increased mandatory firm switching period or the ability to use the incumbent audit firms for an increased range of NAS.³¹⁰

4.98 Supporters maintained that joint audit would enhance audit quality. Mazars wrote that it would do so through the 'four eyes' principle as each firm would be checking the other's work carefully and coming to a common view on subjective and complex issues arising on the audit since that would be forming a joint audit opinion and be jointly responsible for it.³¹¹ Group A also stressed that 'there would be more challenge to judgements' and joint audit would be likely to bring innovations and 'would also increase the perception of auditor independence'.³¹²

³⁰⁸ See: www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/group_a_egian_paper.pdf.

³⁰⁹ See for example, Mazars response to the Remedies Notice.

³¹⁰ GT response to the Remedies Notice.

³¹¹ Mazars response to the Remedies Notice.

³¹² Summary of Group A response hearing, paragraph 15.

4.99 GT wrote that ‘consortia audits would not increase costs for the company and, in some cases, will result in a reduced audit fee for the entire group’; the firm’s experience was that groups that had engaged consortia audits had been ‘very satisfied in terms of both cost and quality’.³¹³ Mazars argued that joint or shared audits would be a less expensive alternative to a remedy of audit firm switching.³¹⁴

4.100 Opponents of the concept, conversely, considered that joint or shared audits would be inefficient and damaging to audit quality. PwC, for example, said that such audits were widely regarded as ‘sub-optimal and inefficient’ and ‘would increase the likelihood of things “falling between” the two (or more) appointed audit firms’; they added to cost and reduced ‘clarity of accountability’ and hence threatened quality.³¹⁵ Deloitte argued in similar terms that joint or component audits were ineffective and disproportionate, adding that ‘the historical evidence of undetected fraud under joint or component audits is most significant. Examples include BCCI, Parmalat and Polly Peck.’³¹⁶

4.101 The FD of Company S, interviewed among the case studies conducted by the CC, said:

It was sensible for the CC not to pursue joint audit. Having experienced joint audit, the lines of demarcation for the audit tended to cause difficulties and it was tough when one firm had to take responsibility for another’s work. The Audit Committee was unlikely to be happy if the group audit simply took a joint auditor’s work on trust.³¹⁷

³¹³ GT response to the Remedies Notice.

³¹⁴ Mazars response to the Remedies Notice.

³¹⁵ PwC response to the Remedies Notice, Annex 3.

³¹⁶ Deloitte response to the Remedies Notice.

³¹⁷ Case Study S.

The Group FD of Company R considered ‘that joint audits did not work – the second auditor often lacked experience and did not add to the work of the primary auditor and, from experience, resulted in less efficient and effective audit’.³¹⁸

4.102 The introduction of a scheme to promote shared or joint audits would, according to its advocates, benefit the audit market, mainly by breaking down barriers to market entry. GT, for example, wrote: ‘over a period of time, the introduction of consortia audits would facilitate the recognition that additional firms are capable of auditing the largest companies, and thus facilitate the involvement of more audit firms in the audit of large listed groups.’³¹⁹ It was also argued (eg by the Group A firms³²⁰) that a scheme to promote joint audits would provide continuity when one of the auditors changed. It ‘should also reduce the risk of the failure or withdrawal from the audit market of one of the dominant auditors or audit firms’.³²¹

4.103 Parties differed markedly on their views of market perceptions. Mazars wrote that joint or shared auditing has a ‘proven track record of delivering benefits’. GT believed that the evidence showed that consortia audit was very effective. It provided the example of one FTSE 100 company which it said had seen evidence that consortia audit could drive better audit quality, service quality, and price. On the back of this, GT said it was getting enquiries from boards and investors as to how consortia audit might work.³²² However, several non-Big-4 firms acknowledged that market perceptions were unfavourable, if only as a result of ‘resistance from the dominant players’ and ‘institutional bias’.³²³ (But GT commented that ‘there was much more of an open mind to consortia audit’.³²⁴) PwC wrote that ‘the almost complete absence of

³¹⁸ Case Study R.

³¹⁹ GT response to the Remedies Notice. See also Kingston Smith response to the Remedies Notice.

³²⁰ www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/group_a_%20firms_pfs_and_remedies.pdf.

³²¹ GT response to the Remedies Notice.

³²² Summary of response hearing with GT, paragraph 43.

³²³ See the Group A firms’ response to the Remedies Notice. See also BDO response to the Remedies Notice.

³²⁴ Summary of response hearing with GT, paragraph 43.

joint audits from the current UK market ... reflects their unattractiveness to companies', and gave examples of companies that it claimed had moved away from joint audits.³²⁵

4.104 Similarly, the non-Big-4 and the Big 4 had different viewpoints on the international experiences of shared/joint auditing. Mazars noted that the requirement to have joint audits in France had made the French audit market the least concentrated in the EU.³²⁶ PwC and KPMG pointed out that other countries had tried and abandoned joint audits on the grounds that they added to cost without benefiting audit quality.³²⁷

Consideration of effectiveness in dealing with AEC

4.105 A theoretical benefit of either shared or joint audit is that the requirement for two audit firms to contribute to the audit opinion on a company's group financial statements may provide an enhanced level scrutiny of the financial statements.³²⁸ However, we do not consider that, by itself, this remedy addresses the AEC that we have provisionally found whereby demand is distorted towards executive management. We consider that other aspects of our remedy package will more effectively address the AEC in this respect (see paragraphs 5.7 and 5.8).

4.106 We also provisionally found that there were barriers to switching and that lack of visibility of audit quality was a contributory factor. Joint or shared audit would lead to greater visibility of audit quality because companies would obtain direct experience of being audited by more than one firm, although we note that depending on the

³²⁵ [PwC response to the Remedies Notice, Annex 3.](#)

³²⁶ [Mazars response to the Remedies Notice.](#)

³²⁷ [PwC response to the Remedies Notice, Annex 3](#) and [KPMG response to the Remedies Notice.](#)

³²⁸ A joint audit requires two audit firms to jointly sign the audit report; shared audit two or more auditors to audit individual subsidiaries or components but with one auditor signing the audit report.

arrangements of the joint or shared audit, the exposure of the AC to both auditors would vary.³²⁹

4.107 We considered whether joint or shared audit would lower barriers to entry. We consider that shared audit might encourage companies to use firms for parts of the audit that they may not have considered for the Group audit, for example because they lacked the necessary global coverage. This could therefore enable firms more easily to gain experience of auditing parts of FTSE 350 companies. However, we did not consider that this effect would be substantial, as companies would retain incentives to engage auditors with the necessary global coverage and experience for the substantial part of the audit.

4.108 In relation to joint audit, we considered that companies would continue to have incentives to engage audit firms who could demonstrate experience and global coverage and that such a remedy would have little effect on barriers to entry.

Assessment

4.109 We have not been able to quantify what the potential cost of imposing shared or joint audit on the market would be, however, we believe that across the market these costs would be potentially significant, particularly if the risk of a reduction in audit quality was to be avoided.

4.110 In relation to increasing visibility of audit quality and addressing distortion in demand we consider that other elements of our proposed remedy package are effective in these respects and do not introduce the potential costs and risks associated with joint/shared audit. Whilst we accept that joint/shared audit has some benefits in relation to lowering barriers to entry and expansion, we were not convinced these

³²⁹ If the second audit firm was auditing overseas or less significant components the group CFO or AC would have less visibility of the quality of their work.

benefits were significant, or certain, and did not justify the potential costs of such a remedy.

4.111 We placed considerable weight on the views of investors who were almost universally opposed to such a remedy on the grounds of additional costs and risks to audit quality.

4.112 On the basis of the above we are not minded to adopt this remedy on the basis of its effectiveness in remedying the AEC and its potential costs.

Shareholder group responsible for auditor reappointment

4.113 In this subsection we:

- (a) note the original discussion of the remedy in the Remedies Notice;
- (b) outline the relevant responses to the Remedies Notice;
- (c) consider if the remedy would be effective in addressing the AEC; and finally
- (d) make an overall assessment of the impact of the remedy.

Remedies Notice

4.114 We considered a remedy whereby a group of shareholders would be appointed to select the auditor, with the aim of addressing the provisional AEC through ensuring a direct link between shareholders and auditors which could reduce independence concerns.

4.115 A group of shareholders would be appointed to represent all shareholders in selecting an auditor (either annually or when there is a tender process). This could be a stronger position for shareholders than having the AC members represent them because the shareholder group would not sit on the board and would therefore not be subject to the pressure of a unitary board. It would also be stronger than the

current situation with a shareholder vote on appointment as the shareholder group would have more active involvement in the process (ie be involved in any tender process etc).

4.116 However, we had a number of concerns about such a remedy, namely that (a) the effectiveness relies on the shareholder group being able accurately to assess auditor options (ie be the expert buyer); (b) in practice if only certain shareholders engaged with this group then it might be that only their interests were represented. At the moment the AC members (and other non-executive directors) are there to represent all shareholders and not a specific subset; (c) it is unclear how/whether this would complement or replace existing ACs and (d) such an arrangement would have to overcome incentives for shareholders to free-ride on the involvement of others.

Responses to the Remedies Notice

4.117 Hermes agreed with the decision not to pursue the remedy.³³⁰

4.118 Deloitte agreed with our decision not to pursue the remedy on the grounds of effectiveness and proportionality. Further Deloitte stated that ‘that the evidence in front of the CC shows that investors do not want such a role’.³³¹ Deloitte also quoted from Oxera’s survey of investors: ‘the interviewees do not want any radical change to investors’ degree of involvement in auditor selection’.³³²

4.119 GT noted the lack of shareholder involvement in auditor appointment prior to the AGM and identified this as potentially problematic as the AGM is ‘usually too late to have sufficient influence on the decision’.³³³ However, GT agreed that a shareholder

³³⁰ [Hermes response to the Remedies Notice](#), p4.

³³¹ [Deloitte response to the Remedies Notice](#), paragraph 12.1.

³³² See www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf, page i.

³³³ [GT response to the Remedies Notice](#), paragraph 9.1.

group could marginalize some shareholder views and conflict with the responsibilities of the AC. GT supported other methods of shareholder engagement.³³⁴

4.120 KPMG agreed with the CC's decision.³³⁵ PwC also supported the CC's decision and referred to the FRC's work on stewardship³³⁶ which identified 'a number of potential problems with this for investors and companies' including:

- (a) confidentiality issues around enhanced reporting;
- (b) risks that engagement with principal shareholders only would disadvantage other shareholders; and
- (c) institutional shareholders may not see the need to be involved in such decisions.³³⁷

4.121 ICAS also supported the decision not to pursue the remedy.³³⁸

4.122 Two Swedish bodies (The Confederation of Swedish Enterprise (Svenskt Näringsliv), Sweden's largest business federation and FAR, the Institute for the Accountancy Profession in Sweden) did not directly support this remedy, but identified the nomination committee, present in Swedish Corporate Governance:

It is our belief that a system with a Nomination Committee, appointed by the shareholders in order to guide the shareholders in their decision to evaluate and appoint the auditor, is superior to a mandatory tendering and switching process in meeting the objective of engaged shareholders. This system also secures the shareholders' right to

³³⁴ *ibid*, paragraph 9.2.

³³⁵ [KPMG response to the Remedies Notice](#), paragraph 10.2.

³³⁶ [FRC, Effective Company Stewardship – Enhancing Corporate Reporting and Audit, January 2011](#).

³³⁷ [PwC response to the Remedies Notice, Annex 3, paragraph 60](#).

³³⁸ [ICAS response to the Remedies Notice](#).

determine when it is appropriate to appoint a new auditor or renew the current auditor's term of office.³³⁹

Consideration of effectiveness in dealing with AEC

- 4.123 In considering the effectiveness of the remedy, we considered how a shareholder group might function differently to an AC. As noted in our Remedies Notice, we do not think that such a group would necessarily be any more able to assess auditor options, or to ensure that some shareholders were at no more an advantage than others.
- 4.124 In response to a submission on the Swedish Nomination Committee we undertook some further research on the Swedish model to understand how it differed to the remedy in the Remedies Notice.
- 4.125 We considered who would sit on such a committee. In Sweden, the members of the committees often directly represent shareholders. In contrast members of UK ACs are required to be independent and thus represent the interests of the shareholders as a whole. It is not clear in the British case how individuals would be identified in a way to make their relationship with the company and their shareholders different to that of AC members whilst at the same time ensuring that the interests of any group, or individual investor were not marginalized.
- 4.126 We further note Deloitte's Center for Corporate Governance which states that the nomination committee's views are not binding on the board and that shareholding of individual companies in Sweden is often very concentrated.³⁴⁰

³³⁹ Confederation of Swedish Enterprise and FAR response to the Remedies Notice.

³⁴⁰ www.corpgov.deloitte.com/site/sweeng/nomination-committee-sweng/.

4.127 If shareholdings are diluted and shared among multiple investors, the interests of each shareholder are unlikely to be able to be represented in the Swedish model and shareholder demands and interests cannot be effectively represented. In the UK, ownership of FTSE 350 shares is heavily diluted and we do not believe that the nomination committee as operating in Sweden would be effective in addressing the AECs identified.³⁴¹

Overall assessment

4.128 We received no responses supporting the remedy as drafted in the Remedies Notice.

4.129 As discussed above, we received one response suggesting the adoption of a nomination committee per the Swedish corporate governance model. In assessing these views, we have considered that the remedy would not be effective for the reasons in the Remedies Notice. We do not have evidence to indicate that a shareholder group would be able to represent the interests of all shareholders or necessarily demonstrate sufficient expertise in purchasing an audit to improve upon the role of the AC.

4.130 Given the likely limitations of the remedy we considered that it would be an inferior substitute for ACs for this function, particularly if ACs are strengthened further in accordance with Remedy 5, Strengthened Accountability of the AC, and other aspects of our remedy package designed to increase the influence of the AC. We are therefore not minded to consider this remedy further.

FRC responsible for auditor appointment

4.131 In this subsection we:

(a) note the original discussion of the remedy in the Remedies Notice;

³⁴¹ When we sought to identify the largest investors in the FTSE 350 for our investor questionnaire we found that the largest institutional investors owned only a small percentage of the total number of shares in most companies.

- (b) outline the relevant responses to the Remedies Notice;
- (c) consider if the remedy would be effective in addressing the AEC; and finally
- (d) make an overall assessment of the impact of the remedy.

Remedies Notice

4.132 We considered a remedy whereby the FRC would be required to appoint auditors for FTSE 350 companies to ensure that shareholder interests were appropriately represented and/or auditor-management familiarity was not a factor in auditor appointment decisions.

4.133 We considered that quality may be enhanced if independence concerns were addressed, although a lack of familiarity of the FRC with the particular circumstance of individual companies might result in ineffective appointments. Such a role would also require a major expansion in the activities of the FRC.

4.134 We therefore considered that other remedy options such as strengthened accountability of the external auditors to the AC (Remedy 5) were likely to be more effective. For these reasons, we concluded that unless other remedy proposals proved unworkable or ineffective then we would not consider this particular option further.

Responses to the Remedies Notice

4.135 Hermes agreed with the decision not to pursue the remedy.³⁴²

4.136 Deloitte agreed with the decision not to pursue this remedy on the grounds of effectiveness and proportionality and stated that it:

would risk giving rise to outcomes that were not in the best interest of companies or their shareholders. It would be a major departure from the

³⁴² [Hermes response to the Remedies Notice](#), p4.

established scheme of corporate governance in the UK, the case for which has not been made out.³⁴³

4.137 GT agreed with us. It stated that the ‘auditor appointment decision should [not] be made by any party other than the company, with adequate input from shareholders. This is because a third party is unlikely to be sufficiently familiar with the particular circumstance of individual companies, which will lead to ineffective appointments’.³⁴⁴

4.138 KPMG agreed with our initial view.³⁴⁵ PwC also agreed and further noted it would disenfranchise investors.³⁴⁶

4.139 ICAS also supported the decision not to pursue the remedy.³⁴⁷

Consideration of effectiveness in dealing with AEC

4.140 As stated in the Remedies Notice, the FRC would be able to be independent in the decision as to which auditor to appoint. However, whilst the FRC might be able to act as an expert purchaser on the basis of technical audit aspects, it would not have sufficient understanding of the nature of individual companies to make a rational assessment on behalf of shareholders. We do not therefore consider this to be effective at remedying the AEC.

Overall assessment

4.141 We believe that this remedy would have high costs associated with it, as it would disenfranchise management, the AC and shareholders. Whilst it would reduce or even remove incentives to satisfy management demand over shareholder demand, it is not clear how shareholders would be able to express if the auditor was failing to

³⁴³ [Deloitte response to the Remedies Notice](#), paragraph 13.1.

³⁴⁴ [GT response to the Remedies Notice](#), paragraph 10.1.

³⁴⁵ [KPMG response to the Remedies Notice](#), paragraph 10.2.

³⁴⁶ [PwC response to the Remedies Notice, Annex 3](#), paragraph 61.

³⁴⁷ [ICAS response to the Remedies Notice](#).

satisfy shareholder demand. Furthermore, it is not clear that optimal decisions with respect of auditor appointment would be achieved by this remedy. We have received no further evidence to contradict this position. We therefore provisionally decide not to pursue this remedy further.

Independently resourced Risk and Audit Committee

4.142 In this subsection we:

- (a) note the original discussion of the remedy in the Remedies Notice;
- (b) outline the relevant responses to the Remedies Notice;
- (c) consider if the remedy would be effective in addressing the AEC; and finally
- (d) make an overall assessment of the impact of the remedy.

Remedies Notice

4.143 We considered a remedy whereby Risk and Audit Committees were mandated to procure independent advice on the conduct of the audit. This might be considered analogous to pension fund trustees receiving independent advice on how pension fund investment managers have performed. This could address the provisional AEC as ACs would be better able to assess the judgement and quality of detailed work of the auditors and would increase the independence of the auditors from management.

4.144 However, we noted that there was nothing to prevent ACs currently from obtaining such advice if they thought this was necessary and yet there were few occasions where this was done. We also considered the costs of such a measure and are wary of imposing additional layers of regulation if other more cost-effective measures are available. We considered that Remedy 5 which strengthens the accountability of the external auditors to the AC was likely to be a more cost-effective option in strengthening the resourcing of the AC and incentivizing auditors to compete to satisfy shareholders rather than management.

Responses to the Remedies Notice

4.145 Hermes agreed with the decision not to pursue the remedy.³⁴⁸

4.146 Deloitte agreed with the CC's decision and stated that:

Other remedies (particularly remedy 5) are more effective and more proportionate. This remedy would be likely to increase cost and bureaucracy without a commensurate improvement in outcomes for customers.³⁴⁹

4.147 GT agreed with the CC's decision and stated that:

this possible remedy could incur a significant level of time and effort which would likely lead to a no greater effective measure than those expressed in sections 4 and 5 of the 'Remedies the CC are exploring' section.³⁵⁰

4.148 KPMG agreed with our view.³⁵¹ PwC also agreed and stated that ACs 'already have the ability to procure independent advice on audit advice'. Further PwC agreed with the CC's view that 'strengthening the accountability of external auditors to ACs is a more cost-effective way of aligning audits with shareholders' needs'.³⁵²

4.149 ICAS also supported the decision not to pursue the remedy.³⁵³

Consideration of effectiveness in dealing with AEC

4.150 We did not identify any barrier that acted to prevent ACs from obtaining advice or support from a third party. We do not therefore believe that this remedy would

³⁴⁸ [Hermes response to the Remedies Notice](#), p4.

³⁴⁹ [Deloitte response to the Remedies Notice](#), paragraph 14.1.

³⁵⁰ [GT response to the Remedies Notice](#), paragraph 11.1.

³⁵¹ [KPMG response to the Remedies Notice](#), paragraph 10.2.

³⁵² [PwC response to the Remedies Notice, Annex 3](#), paragraph 62.

³⁵³ [ICAS response to the Remedies Notice](#).

effectively deal with the AEC and as stated in the Remedies Notice we do not believe that this was a cost-effective remedy.

Overall assessment

4.151 In summary we believe that the costs of implementing this remedy are considerable in relation to the expected benefit. Under the UK Corporate Governance Code, ACs must disclose how they have discharged their duties and we believe our recommendation to introduce an advisory vote, combined with recent changes to the AC report are effective in promoting shareholder interests.

4.152 We have received no further evidence supporting this remedy and provisionally decide that we will not pursue this remedy.

5. The proposed package of remedies: effectiveness and proportionality

Introduction

5.1 Our analysis of the options and the provisional decisions set out in Section 3 leads us to propose the following package of remedies:

- Remedy 1: An Order requiring periodic tendering of statutory audit services and a recommendation to the FRC to amend the UK Corporate Governance Code in line with the Order (see paragraphs 3.3 to 3.176).
- Remedy 2: Recommendations to the FRC to take action in relation to AQR and reporting (see paragraphs 3.177 to 3.257).
- Remedy 3: An Order prohibiting clauses in loan agreements that restrict choice of auditor, together with a recommendation to the LMA (see paragraphs 3.258 to 3.312).
- Remedy 4: A recommendation to FRC to amend the UK Corporate Governance Code and the Stewardship Code in relation to shareholder engagement (see paragraphs 3.371 to 3.426).

- Remedy 5: An Order extending the accountability of the external auditor to the AC (see paragraphs 3.313 to 3.370).
- Remedy 6: A recommendation to the FRC to take action in relation to AC reporting requirements (see paragraphs 3.427 to 3.477).
- Remedy 7: A recommendation to the FRC to take action in relation to a secondary competition objective (see paragraphs 3.478 to 3.525).

5.2 In the remainder of this provisional decision, we:

- (a) describe how the proposed package of remedies addresses the AEC and the resulting customer detriment which has provisionally been found (paragraphs 5.3 to 5.13);
- (b) consider the effectiveness of the package, which covers the extent to which the remedies are capable of effective implementation, monitoring and enforcement, the timescale over which the remedies will take effect, the consistency with other rules applicable to the audit market, and the coherence of the package of remedies (paragraphs 5.14 to 5.38);
- (c) consider the effect of any action on any relevant customer benefits (RCBs) (paragraphs 5.39 to 5.48); and
- (d) assess its proportionality (paragraphs 5.49 to 5.93).

How the proposed package of remedies addresses the AEC

5.3 We discussed the rationale for each element of the remedy package in Section 3. In this section, we set out how the remedy package works as a whole to remedy the AEC and the resulting customer detriment that we provisionally found. We look first at the contribution of each element of the remedy package to addressing the AEC. We then discuss the synergies between the elements of the remedy package and some important common themes.

Contribution of each element of the remedy package

5.4 We discuss in detail in Section 3 how we expect each element of the remedy package to contribute to addressing the AEC, both individually and in combination with certain other remedies. In summary we consider the contribution of each remedy to be as follows:

- Remedy 1: More frequent tendering of audit services will strengthen the bargaining position of companies, both during the tender process and between tender processes. We also consider that it will reinforce the influence of the AC on the selection of auditor, thus ensuring that competition is directed towards meeting shareholder requirements. In addition, it will reduce barriers to entry and expansion.
- Remedy 2: More frequent reporting by the AQR team will strengthen the bargaining position of companies by providing them with more information on the audit quality of their incumbent audit firm and facilitating comparison of audit firm quality. It will also contribute towards reducing barriers to entry.
- Remedy 3: Prohibition on restrictions on auditor choice in loan agreements will reduce barriers to entry for Mid Tier firms.
- Remedy 4:
 - (a) The recommendation for the AC to seek shareholder views on audit matters, for example at the AGM, and explain how shareholder concerns have been addressed, will address information asymmetries and enable shareholders to exercise their powers more effectively. It will encourage ACs to take the views of shareholders into account when appointing or reappointing auditors.
 - (b) The recommendation to update the Stewardship Code to emphasize that investors should engage on audit issues will encourage institutional investors to engage with companies on matters concerning external audit, and to exercise their powers more effectively with regard to auditor appointment.

(c) The requirement for companies to hold an advisory vote on the Audit Committee Report will incentivize ACs to discharge their responsibilities in relation to the external audit in the interests of shareholders and to take account of shareholder views.

In combination, the measures we are proposing under Remedy 4 will promote more effective shareholder engagement and contribute towards ensuring that competition is focused on their requirements.

- Remedy 5: The enhanced accountability of the auditor to the AC will enhance AC influence in the external audit relationship, thus directing competition towards satisfying the requirements of the AC whose interests are more closely aligned with those of shareholders.
- Remedy 6: Extended AC reporting on AQR team reports will provide companies with more information regarding the audit quality of non-incumbent firms, thus increasing bargaining power, and give shareholders more information regarding audit quality and AC effectiveness thereby promoting shareholder engagement and directing competition towards meeting their needs.
- Remedy 7: The competition objective of the FRC will act to ensure that it takes appropriate account of the role of competition in facilitating high-quality audit when formulating policy.

Synergies and common themes

5.5 Broadly, we consider that the remedies we are proposing individually contribute to remedying the AEC in three ways: first, to improve the bargaining position of companies vis à vis external audit (principally remedies 1, 2, 3, 6); second, to enhance the influence of the AC in the relationship with the external auditors (principally remedies 1, 4, 5) and third, to promote shareholder engagement in the audit process (principally remedies 4, 6). Remedy 7 has a general role. However,

there are also important interactions between the proposed remedies, which we discuss below.

- 5.6 We consider that increased tendering will both enable companies to assess more frequently whether their audit service is competitive, and the information produced by going out to tender will increase their bargaining position between tender processes. However, we are aware that enhanced competition, if directed towards the demands of executive management, might lead to a less thorough or sceptical audit. Thus, we consider that any increase in competitive pressure should be accompanied by measures to ensure that competition is directed towards the demands of shareholders, and in particular that shareholder interests are appropriately taken into account in fee negotiations and auditor selection decisions.
- 5.7 We consider that our remedies designed to enhance the influence of the AC in the relationship with the external auditors will work in combination with more frequent tendering to ensure that competition is better focused on shareholder demand, because the AC has a particular role to ensure, on behalf of the board, that the interests of shareholders are properly protected. The influence of the AC, in combination with more frequent tendering, should help to ensure that competitive outcomes for shareholders are achieved and that shareholders can be more confident that their interests have been at the forefront of any tender process and subsequent appointment decision.
- 5.8 Further, we consider that our remedies designed to promote shareholder engagement will work in combination with remedies to require more frequent tendering and enhance AC influence to enable shareholder interests to be better reflected in auditor appointment decisions. We consider that our remedies will encourage more information flow between companies and investors in relation to external audit and

thus allow ACs to more fully understand any shareholder concerns on the subject, and so better to act on them. In conjunction with the recent FRC initiatives to improve AC and auditor disclosures in annual reports, our remedies ensure that an appropriate framework is in place to allow shareholders to engage with and influence audit-related matters. It is necessarily up to shareholders and their representatives to make use of it, and thus play their part in promoting competition in the market.

5.9 We consider that more frequent tendering may have the dynamic effect of increasing choice, as firms will have increased incentives to invest in developing their capabilities in order to win engagements, since they will be able to predict with confidence when opportunities to tender will arise. We consider that this will apply to both Mid Tier firms in general, and to Big 4 firms in relation to sectors where they are currently less strong. We consider that this will work in combination with our remedy prohibiting restrictions on auditor selection in loan agreements and our remedy to increase reporting by the AQR team, and thus incentivize audit firms other than the Big 4 firms to invest in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth.

5.10 We have considered the role of the FRC carefully in formulating our remedy proposals, and we note that it has evolved over time into an agency that is increasingly well equipped to provide high-quality independent regulation to the audit market. We found that the work of the FRC's AQR team was well regarded, considered carefully by audit firms and companies, and so we found that it had an important role to play in promoting competition between audit firms whilst safeguarding audit quality. We welcomed the recent changes to the UK Corporate Governance Code to increase tendering and expand AC reporting and we saw these as beneficial steps promoting competition.

5.11 However, we considered that further steps were required to increase the resources of the AQR team, to strengthen the role of the AC, and to encourage transparency of AQR grades. These measures will complement other measures in our overall package of remedies designed to improve visibility of audit quality and enhance AC effectiveness. We also considered that a change to the FRC's objects to have regard to competition would ensure that it places appropriate weight on the role of competition in facilitating high-quality audit. We are necessarily reliant on the FRC to take our recommendations forward, and to ensure that it secures the appropriate funding to do so. In doing so, we consider that the FRC will further strengthen its role as an accountable, transparent, and independent regulator of the audit industry.

Conclusion on how the proposed remedy package addresses the AEC

5.12 In summary, we consider that our remedies will work in combination to ensure that through an increase in company bargaining power, competitive rivalry and choice in the audit market should increase, and that this rivalry will be better directed towards satisfying the requirements of shareholders for high-quality audit.

5.13 We consider that the package will address both aspects of the AEC that we provisionally found: namely that companies lack bargaining power with regard to their incumbent auditor and that competition is likely to be directed towards the demands of executive management rather than those of shareholders.

5.14 We now turn to assessing the effectiveness of the package we propose.

The effectiveness of the remedy package

5.15 In evaluating the effectiveness of the proposed remedy package we considered the following factors:

- (a) The means by which the remedies are capable of effective implementation, monitoring and enforcement.
- (b) The timescale over which the remedies will take effect.
- (c) Consistency with other rules and codes.
- (d) The coherence as a package of remedies.

Implementation, monitoring, and compliance

- 5.16 In developing each of the remedy options, we considered how each measure could best be implemented, monitored and enforced. Our provisional decisions setting out how each measure should be implemented and the reasons for this are summarized in Section 3.
- 5.17 In deciding whether the CC should take action itself to remedy the AEC in our provisional findings or should recommend the taking of action by others, we had regard to the following considerations.
- 5.18 Where the CC takes action itself, it has the choice of implementing remedies by accepting undertakings from the relevant parties and/or by making an order. In making this decision, we took into account the extent to which our proposed remedies fell within our order-making powers³⁵⁴ and relevant practical issues, such as the number of parties which would have to give undertakings, and the likely delay and complexity of negotiating undertakings with so many parties.
- 5.19 Where it appeared that a proposed remedy came within our order-making powers, we took into account the likely costs of compliance with our orders, and that the effectiveness of any remedy may be reduced if elaborate monitoring and compliance programmes are required. The Act gives the OFT the formal duty of keeping under

³⁵⁴ These are set out in section 161(3) of and Schedule 8 to the Act.

review the carrying out of and the effectiveness of enforcement orders.³⁵⁵ However, we also took into account that the likelihood of compliance is increased when the operation and implications of remedies are clear to the persons to whom they are directed, and where the arrangements for monitoring compliance are simple to carry out.

5.20 Where we considered that we did not have jurisdiction to make orders in respect of a proposed remedy, as in the case of proposed remedies which involve amendment of the UK Corporate Governance Code and the Stewardship Code, we decided to make recommendations to the FRC (the relevant regulator) to take relevant action.

5.21 Based on the above considerations, and our detailed assessment of each remedy option in Section 3, we provisionally conclude that our remedies package is capable of effective implementation, monitoring, and enforcement.

Timescale over which the remedies will take effect

5.22 In considering the timescale over which these remedies are likely to take effect, we considered both the time that it is likely to take to implement the remedies and the time that it is likely to take for the remedies, once implemented, to remedy the AEC and the resulting customer detriment.

- *Orders*

5.23 The CC normally expects to make an order in relation to those matters that we are implementing ourselves within a period of around six to nine months following publication of our final report. In this case we would expect the order on firms in

³⁵⁵ Section 162(1) and (5) of the Act.

relation to engagement with ACs (Remedy 5); and the order in relation to auditor clauses in loan agreements (Remedy 3) to take effect by 1 October 2014.³⁵⁶

5.24 We expect the order in relation to mandatory tendering to have effect from 1 October 2014 with a transitional period that will phase in the new arrangements over the course of five years (one AEP cycle) and will result in a relatively small increase in the number of tender processes held in the short to medium term (one to five years) in comparison with the number that we expect to be held under the current FRC guidance. We consider that these transitional arrangements give firms and companies time to respond to the prospect of significantly increased tendering activity, for example by ensuring that appropriate resources are in place.

5.25 We consider that as the practice of going out to tender becomes more familiar to company management, the process will become more efficient, and companies will become more familiar with evaluating alternative bids. In addition, any perception that going out to tender and switching costs are higher than they are in reality will diminish as companies gain more experience in these areas (although we accept that the costs will nevertheless remain significant for some companies). We also consider that any stigma associated with going out to tender the audit engagement, for example the potential suspicion on the part of shareholders that such a move is a result of a 'falling out' over a financial reporting matter, will be reduced in an environment where use of tender processes becomes significantly more common.

- *Recommendations*

5.26 For the shareholder-auditor engagement remedy (Remedy 4) and extended reporting requirements in both the Audit Committee Report and auditor's report (Remedy 6) we provisionally recommend that the FRC make amendments to the UK Corporate

³⁵⁶ This takes into account consultation on the draft Orders and the Government's suggested common commencement dates of 6 April or 1 October for new legislation and regulations, aimed at minimizing burdens on business.

Governance Code and, for Remedy 4, the Stewardship Code by 6 April 2014. The proposed recommendations in relation to these governance codes are largely a change or addition to existing practices or guidance, rather than creating new areas of best practice. We would therefore expect such recommendations to take less time to develop and implement than measures requiring the introduction of a new regulatory framework. We therefore consider that it is achievable to implement these recommendations within the proposed time frame.

5.27 We acknowledge that the AQR remedy (Remedy 2) will take some time to come into effect, as it may take some time for the AQR team to expand its resources to undertake more frequent reviews, the total number of reviews being undertaken, and the results of those reviews being reported to shareholders through the AC report. Therefore, we recommend that the FRC implement the changes as soon as reasonably practicable.

5.28 The CC welcomes views on the proposed implementation timing for each of the selected remedies.

- *Other factors*

5.29 A number of other factors will affect the timescale over which our remedies will have an effect on market outcomes.

5.30 We expect some of the measures that we propose to have dynamic effects that may be felt in the longer term. Such effects include the effects on firms' incentives to invest in the expertise and experience required to win FTSE 350 audit engagements through tenders in specific sectors. We expect the firms to take some actions in the short term in anticipation of the expected increase in companies going out to tender that will arise as a result of our remedy package. On the other hand, we recognize

that development and execution of competitive strategies in response to increased tendering, eg investments in additional capability, may evolve over a period of time as the market develops.

- 5.31 Even so, once our remedies have been implemented we expect them to have an immediate effect on the incentives of firms, both within and outside the relevant market. In particular we expect that an increased threat of competition from potential rival audit firms for any given engagement would have an immediate effect on incentives. We expect the certainty that companies will go out to tender on a regular and more frequent basis to increase incumbent firms' incentives to ensure that they provide a competitive product thereby reducing the risk of losing in a forthcoming tender process.
- 5.32 In relation to the promotion of shareholder interests in the competitive process, we consider that the recent changes to the Guidance on ACs to encourage ACs to disclose more information about how they have discharged their responsibilities to shareholders in relation to the external audit should already affect AC incentives, as they apply for reporting periods beginning 1 October 2012. Whilst the first reports under the new Guidance will not be published until late 2013/early 2014, we consider that the process of preparation to report should be underway. We consider that the recent changes should therefore contribute to ensuring that the AC has appropriate influence in relation to external audit with immediate effect.
- 5.33 Equally the recent changes to the Audit Report in ISA 700 will apply to reporting periods beginning on 1 October 2012 and audit reports on these periods will start to be published in early January 2014. Audit firms should already be planning to make the additional disclosures required by ISA 700 and, in some cases, are already

doing so.³⁵⁷ We expect that our remedy package will translate into improvements in market outcomes, including a more competitive product which better meets the demands of shareholders, within one to two years of implementation. We expect that remedies to enhance the influence of ACs and to ensure that shareholder interests are better represented may take between three to five years to be fully reflected in the competitive environment, and remedies to increase tender activity may take up to seven years to be fully effective for all companies. Similarly, the AQR remedy may take seven to ten years to be implemented and for a full cycle of FTSE 350 reviews to be conducted. Improvements in market outcomes in relation to increased choice may take a similar period of time to materialize as firms develop and execute strategies in response to heightened competition.

Consistency with other regulations

5.34 Where possible we have sought to build on the existing regulatory framework that applies in the statutory audit market. Where considered effective, we have recommended changes to the UK Corporate Governance Code and Stewardship Code (in relation to the AC reporting and shareholder engagement), and we have recommended changes to the existing AQR framework. Where we had doubts as to the timeliness or effectiveness of recommendations, we have made Orders, for example to prohibit firms and companies from entering into agreements for audit engagements where the company has not gone out to tender for a period of more than five years (subject to an ability to postpone a tender process for a maximum of two years in exceptional circumstances); to require firms to provide information to other firms participating in a tender process if requested by the company; and to require firms to ensure that fee negotiations are conducted with the ACC. In due course we would expect such orders to be reflected in the UK Corporate Governance

³⁵⁷ See for example, Vodafone Group Plc annual report 2013, Independent Auditor's report to the members of Vodafone Group plc: www.vodafone.com/content/annualreport/annual_report13/downloads/audit_report_on_the_consolidated_financial_statements.pdf.

Code and associated guidance, as we would expect the FRC to have an interest in providing companies with a comprehensive view of the relevant body of regulation.

5.35 In relation to the prohibition of clauses that restrict choice of auditor in loan agreements, we note that the UK Corporate Governance Code contains a requirement on ACs to report any such clauses as discussed above. We would expect the FRC to revise its guidance to make it clear to companies that these clauses are prohibited in loan agreements going forward.

5.36 We considered the interaction of our remedy package with the proposals currently under discussion by the EU, which we describe in paragraphs 2.23 to 2.26. At the time of writing there is significant uncertainty over the nature and timing of any EU action in this area. It is possible that future EU action may obviate the need for some of our remedies, for example if wider in effect, or otherwise necessitate changes to them, for example if they are contradictory. To the extent that it is known with any certainty, we will take the EU position into account when formulating our final remedy proposals.

Coherence as a package

5.37 As discussed in paragraph 5.12, the proposed remedies will work coherently in combination to address both aspects of the AEC we have provisionally found.

Conclusion on effectiveness of remedy package

5.38 Based on the assessment in paragraphs 5.14 to 5.38 we provisionally concluded that this package of measures would be effective in addressing the AECs that we have provisionally identified and, as a result, would also substantially reduce the customer detriment that flows from the AEC. We expect the remedy package to have a substantial impact on the AEC and resulting detriment within two to three years of

publication of our final report. We accept that the full effect of our remedy package may not be felt for seven to ten years, to allow time for a complete cycle of audit tender processes, and of AQR reviews, and for the dynamic effects of increased competition to take effect.

Relevant customer benefits

5.39 In deciding the question of remedies, the CC may also have regard to the effect of any action on any RCBs of the feature or features of the market concerned.³⁵⁸

5.40 RCBs are limited to benefits to relevant customers in the form of:

- (a) lower prices, higher quality or greater choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or
- (b) greater innovation in relation to such goods or services.

5.41 The Act provides that a benefit is only an RCB if the CC believes that:

- (a) the benefit has accrued as result (whether wholly or partly) of the feature or features concerned or may be expected to accrue within a reasonable period of time as a result (whether wholly or partly) of that feature or those features; and
- (b) the benefit was, or is, unlikely to accrue without the feature or features concerned.

5.42 We considered whether there were any RCBs which we should take account of in formulating our remedies.

5.43 In doing so, our principal consideration was benefits accruing to shareholders.

³⁵⁸ The Act, section 134(7).

- 5.44 We considered parties' submissions on RCBs. PwC and Deloitte submitted that the feature that companies and audit firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away, gives rise to continuity benefits that are beneficial for shareholders and which must be taken into account by the CC when deciding on the appropriate package of remedies.³⁵⁹
- 5.45 Given that we are not proposing to introduce a remedy to compel companies to switch audit firms because we found that other remedies were more effective in addressing the AEC that we provisionally found, (see paragraph 4.66), we do not consider that our remedy package disturbs any continuity benefits that may result from long-term company-auditor relationships. If a company chooses to switch auditor following a tender process, it will be doing so in the expectation that the benefits of switching outweigh the loss of continuity benefits.
- 5.46 We considered whether more frequent tendering would adversely impact the rigour of the processes thus increasing the risk of appointment of a firm that was not in fact best placed to offer optimal levels of quality and value.³⁶⁰ As discussed in Remedy 1 (see paragraphs 3.105 to 3.150), we found that this would not be the case.
- 5.47 We considered the scope for the remedy package to increase audit fees, as the ACC may have less interest in keeping fees low than the FD, who has traditionally conducted fee negotiations. We considered that ACCs were capable and financially literate individuals who could be expected to strike an appropriate balance between obtaining an audit fee that was not unduly generous and ensuring that audit scope was sufficient to give the assurance that shareholders demand. We also considered that the ACC would be able to seek advice from members of the executive team, including the FD, and external contractors regarding the scope of the audit and the

³⁵⁹ Deloitte response to the Remedies Notice; PwC response to the Remedies Notice, Annex 3.

³⁶⁰ See Deloitte response to the Remedies Notice, paragraphs 3.20–3.22.

appropriate fee. We acknowledge that some fee increases might occur in circumstances where the ACC considered that the audit fee would otherwise be too low to provide an effective audit. However we did not consider that any consequential upwards pressure on fees in these circumstances could be considered to be removing a relevant customer benefit—rather we saw this as a natural consequence of aligning competition with shareholder interests.

5.48 We have not identified any other potential relevant customer benefits deriving from the features that we identified in our provisional findings.

Assessment of proportionality

5.49 We evaluated whether this package would be a proportionate response to the AEC that we have identified by considering the following four questions.³⁶¹

(a) Is the remedy package effective in achieving its aim?

(b) Is the remedy package no more onerous than necessary to achieve its aim?

(c) Is the remedy package the least onerous if there is a choice?

(d) Does the remedy package produce adverse effects which are disproportionate to the aim?

5.50 KPMG in its response to our Remedies Notice observed that '[i]n considering proportionality it is therefore incumbent on the CC to conduct a thorough assessment of the expected costs and benefits of each of the remedies options'.³⁶² We have conducted such an assessment and the factors that we have taken account of in relation to individual remedies are set out in detail in Section 3.

5.51 However, in view of the interconnections between the various remedies outlined above we consider it important to assess the proportionality of the remedies package

³⁶¹ These four aspects overlap to some extent. We have combined discussion of (b) and (c) in the text that follows.

³⁶² [KPMG response to the Remedies Notice](#), paragraph 1.5.

as a whole. This approach is supported by other respondents. PwC said that '[i]t is essential to assess such a package of remedies holistically rather than assessing each individual component in isolation'.³⁶³ GT noted that 'we believe the proposed interventions ... need to be taken together and considered in aggregate'.³⁶⁴

Effective in achieving its legitimate aim

5.52 We provisionally concluded in paragraph 5.38 that this package of remedies would be effective in addressing the AEC that we have provisionally found.

No more onerous than necessary and less onerous if there is a choice

5.53 We tried where possible to facilitate the proper functioning of competition through ensuring that the correct incentive framework is in place, rather than through more intrusive regulation. For example, we sought to ensure a framework by which to encourage ACs and investors to communicate over audit issues and we expect this to be effective, although we acknowledge that this depends to some extent on whether investors make use of the opportunities afforded to them. Similarly we consider that our audit tendering remedy and AC remedy will establish a framework in which the AC is empowered to act in shareholders' interests and thereby avoid more intrusive regulation such as requiring periodic switching of audit firms.

5.54 Each element of the remedy package is necessary in order to achieve as comprehensive solution as is reasonable and practicable to the AEC. As set out in paragraphs 5.5 to 5.13 the remedy package comprises a set of complementary measures, each of which contributes to remedying the AEC by addressing one or more of the features giving rise to the AEC. We have not pursued options, such as joint audit, or restrictions on NAS, where we did not consider that they would contribute materially to the effectiveness of the remedy package.

³⁶³ PwC response to the Remedies Notice, paragraph 3.3.

³⁶⁴ GT response to the Remedies Notice, covering letter, paragraph 7.

5.55 We have been careful to ensure that the design of individual elements of the remedy package is not more onerous than necessary to remedy the AEC (see Section 3). We have chosen not to depart from the principle of 'comply or explain' to tendering at five years (although we have recommended a limit of two years to explaining) as we judged this to be more intrusive than necessary to address the AEC that we had found. Neither have we sought to mandate the form of the tendering process companies should follow, preferring to leave companies with the flexibility to determine the approach that is most suitable for their circumstances.

5.56 We are therefore satisfied that the remedy package is no more intrusive than necessary to remedy the AEC.

5.57 In developing our proposed package of remedies we considered a wide range of options. We have consulted parties on alternative specifications of remedy options and on different approaches to addressing the AEC. We have not been able to identify any less onerous remedy options that would be as effective as the measures that we propose to take forward.

5.58 We were therefore satisfied that we had chosen the least onerous remedy package from the effective options available to us.

Does not produce adverse effects that are disproportionate to the aim

5.59 In reaching our judgement about whether to proceed with the remedy package we have considered its potential effects, both positive and negative, on those parties most likely to be affected by it. In reaching this judgement, we have paid particular regard to the potential impact of these remedies on FTSE 350 companies and have also had regard to the impact on audit firms and other affected parties, including the FRC.

5.60 Our detailed assessment of the potential adverse effects of each of the individual remedy options that we are proposing to take forward is set out in Section 3. We now set out what we judged to be the most important considerations that were relevant to our assessment of whether the adverse effects that we identified were disproportionate when compared with the benefits that our remedy package aims to achieve.

Benefits of the remedy package

5.61 In accordance with our guidance, in considering how markets may develop with remedies in place, the CC will consider both benefits that can be quantified and have a high probability of materializing (such as lower prices) and benefits that are harder to quantify and are more uncertain (for example, the dynamic benefits of increased rivalry on productivity and innovation). Both types of benefit are important.³⁶⁵

5.62 As described above, we consider that the various elements of the remedy package will work in combination to address the AEC that we have provisionally found by increasing company bargaining power and redirecting competition towards the demands of shareholders. Our remedy package is directed at addressing the AECs that we provisionally found. We now consider the extent to which our package of remedies would reduce the customer detriment that we have identified. We discuss the nature of the detriment arising from the AEC in Section 1.

5.63 The most important effect of our proposed remedy package will be to increase confidence in the quality of the audit product. In our discussion of detriment in Section 1, we explain how improving trust and confidence in audit could have economic benefits in terms of improved corporate governance and lower cost of capital. We discuss above that shareholders currently perceive audit quality only

³⁶⁵ CC3 (Revised), paragraph 351.

indirectly and the lack of visibility that currently exists means that these perceptions may at times depart from reality. In the absence of direct information about audit quality, shareholders rightly place considerable weight on the AC to uphold their interests in this respect. We expect our remedies to increase confidence in external audit and in the effectiveness of the AC as follows:

(a) Remedies to increase the frequency of tendering will:

- (i) demonstrate that the AC has subjected the audit relationship to open market review on a periodic basis, and will thus reduce the perception of a 'familiarity threat'; and
- (ii) reassure investors that audit firms have better incentives to deliver a service that is aligned with AC and so shareholder demand.

(b) Remedies to enhance the influence of the AC will:

- (i) Improve shareholder confidence in the effectiveness of the AC in ensuring that auditors are not unduly influenced by executive management when determining audit scope, approach and fees, and when resolving audit issues. As a result shareholders can expect a greater emphasis on professional scepticism and thoroughness; and
- (ii) in combination with more frequent tendering, give shareholders confidence that competition is better aligned with shareholder interests.

(c) Remedies to enhance AC reporting will improve transparency of the performance of the AC and will increase transparency of audit quality through publication of AQR grades. This will:

- (i) ensure that ACs are aware of their responsibilities and take them seriously;
- (ii) improve shareholder awareness and confidence in the role of the AC and in how it has discharged its responsibilities (and so that AC incentives are well-aligned with shareholders' interests);

- (iii) provide shareholders with more information on which to base their views about audit quality, and about the extent to which any quality problems are widespread or otherwise;
- (iv) provide shareholders with increased confidence that quality issues will be discovered and dealt with effectively by the AC; and
- (v) provide shareholders with information on which to engage with companies on matters concerning external audit, thus fostering dialogue and trust.

5.64 In relation to the lack of company bargaining power that we provisionally found, we consider that more regular tendering, in combination with other remedies, will ensure that companies make regular assessments of the benefits of changing audit firm and that these are based on accurate information. If it finds that there would be benefits to changing audit firm, it will need to consider whether the costs of switching outweigh these benefits. Information on the costs and benefits of switching auditor will be better specified because companies and auditors will over time become more familiar with the process of tendering and switching auditor, and uncertainty and misconceptions will thus be reduced.

5.65 Additionally our remedies to increase the influence of the AC, and promote shareholder engagement, will ensure that appropriate weight is put on the benefits that may accrue to shareholders as a result of a change in auditor, and thus ensure that customer bargaining power is exercised on the right parameters.

5.66 Increased opportunities to tender will reduce barriers to entry and expansion and incentivize firms, both Big 4 and Mid Tier, to invest in the necessary capability to win selected engagements. Our remedy to prohibit restrictions of auditors in loan agreements will reduce barriers to entry facing the Mid Tier firms. We consider that in

combination the effect of these remedies will be to expand choice and hence contribute towards effective competition.

- 5.67 We consider that in combination our remedy package will result in enhanced competitive rivalry among audit firms, which we expect to benefit companies and their shareholders in the form of a product that better meets their needs.
- 5.68 As discussed in paragraphs 1.37 and 1.38 the precise configuration of the competitive product that we expect to emerge as a result of our remedy package is difficult to specify and is likely to vary considerably between companies. Nevertheless we consider that the benefits of improving competition, both in terms of increasing rivalry and changing the dimensions on which rivalry takes place, are considerable. We attach significant weight to the public benefits³⁶⁶ of improving confidence in the audit market taking into account the important role of audit in the corporate governance framework.
- 5.69 In paragraph 1.41 we note that very small increases in shareholder value or downwards movements in the cost of capital as a result of improvements in audit quality and confidence in financial reporting could have large financial benefits for the economy in the order of billions of pounds.
- 5.70 In the light of the comprehensive nature of the remedy package and its effectiveness in achieving its aims in respect of improving competition, we expect the customer benefits to be significant.

³⁶⁶ As set out in Section 1, the Act requires us to consider the effect on customers in a wider sense.

Adverse effects of remedies

- 5.71 We have considered the negative effects of our remedies including the costs to business. Such negative effects may arise in various forms, such as:
- (a) A remedy may result in implementation costs and ongoing monitoring and compliance costs.
 - (b) A remedy may result in unintended distortions to market outcomes. Such distortions may adversely affect the interests of customers and reduce economic efficiency.
 - (c) A remedy may remove an RCB.
- 5.72 We consider the costs, including monetary and non-monetary costs, of each of our remedies in detail in Section 3.
- 5.73 The costs of the audit tendering remedy fall largely on companies in running tender processes and audit firms in participating in them.
- 5.74 We found that the costs incurred by companies were hard to quantify because there were few incremental monetary costs and tender processes largely involved the opportunity cost of management time. Costs appeared to vary according to the complexity of the company, as would be expected. We considered that the costs of running the tender could be controlled by companies and were capable of reduction in the event that tenders were held more frequently. This could be achieved through efficient tender process design and the timing of the tender process to avoid periods of high workload. We also considered that our remedy requiring audit firms to make available information to bidding firms if requested by the company could improve efficiency of the tender process. In the normal course of events, we would expect the individuals concerned to manage their time and responsibilities effectively and to deal with one additional tender process every ten years (compared with the number that

they would otherwise have to run under the recent revisions to the Code) as part of their portfolio of responsibilities. We accept that there will be times when the cost to the company of conducting a tender process could be particularly high, if the tender process fell during a period of intense corporate activity, for example M&A, and as a result have proposed that companies should be able to delay going out to tender for up to two years to avoid such circumstances where the effective cost of management time is high.

5.75 We considered the potential adverse effects of increased tendering on companies' incentives to run an effective tender process (see paragraphs 3.105 to 3.132). It is likely that in some instances companies will design tender processes that are more selective and invite fewer firms to compete in them as a result of a more rigorous pre-selection process. We think that if this is the case, the firms selected will retain incentives to compete aggressively and hence we do not consider that there will be a reduction in the effectiveness of tenders by increasing the frequency of tenders to every five years. Further, the recently introduced requirement for the AC to explain the approach taken to the appointment or reappointment of the external auditor in its report to shareholders, and the additional requirements proposed in our remedies package to increase the influence and accountability of ACs, lead us to consider that companies will ensure that the tender process is thorough, albeit we consider that companies may find ways to run these processes more efficiently. We note that the FRC is developing guidance on the conduct of effective tender processes. We also consider that firms are unlikely to participate in a tender process that is not designed to give them the necessary information that they need to compete effectively, and this would act as a discipline to ensure that companies run effective tender processes.

- 5.76 We considered the extent to which firms would incur additional costs in preparing for and participating in an additional 35 tender processes a year (which would result from going out to tender at an average of every five years rather than ten years). We estimated that the costs to firms, in terms of staff time, in participating in an additional 35 tender processes annually could be between £12.6 million and £23.6 million³⁶⁷ annually. We considered this range to be at the upper end of likely actual costs because: (a) we would expect firms to realize efficiencies as a result of more frequent tendering, and (b) the real opportunity cost of staff time would be lower because tender processes were typically held outside of the busy period for audit work. Further, we considered that a significant proportion of this time would be diverted from marketing activity that currently occurs outside of tender processes. On this basis, we estimated the incremental costs to be less than £10 million per year.
- 5.77 In relation to the provision of information to firms participating in tender processes if requested to do so by a company, we considered that because this information pre-existed as part of the audit file, firms would incur few³⁶⁸ additional costs as a result of this aspect of the remedy.
- 5.78 We also considered the potential negative effect on firms' incentives to compete in tender processes as a result of companies going out to tender every five years. We expect significant displacement of indirect marketing activity as these resources are redirected towards competing in tender processes. We consider that with the advent of more frequent tendering, companies may be less receptive to marketing approaches from firms outside of a prescribed tender process. This could lead to more efficient use of resources on the part of firms, as efforts are directed towards competing in tender processes and away from encouraging companies to go out to tender in the first place.

³⁶⁷ Range based on [redacted] data and in 2005 prices.

³⁶⁸ We accepted that some costs would be incurred in ensuring that no commercially sensitive information was disclosed.

- 5.79 We do not accept the argument that firms' resources are constrained such that their ability to participate in more tender processes would be affected (see paragraphs 3.116 and 3.117).). In addition we considered that the market position and reputation of a firm would be risked by non-participation or poor performance within a tender process. On balance, we do not believe that going out to tender every five to seven years would result in less intensive competition for audit engagements. In an environment where the threat of a switch of audit firm is heightened as a result of more frequent tendering, it is reasonable to expect that a firm will not lightly decline to tender and risk significant erosion in market share.
- 5.80 We found that remedies addressing the role of the AC and shareholder engagement did not have significant costs associated with them. Some additional remuneration for ACCs to reflect their increased responsibilities is likely to be necessary, but we considered that this would be partly mitigated by the opportunity cost of time saved by the FD and his team (for example, on the fee negotiation). Some additional time on the part of institutional investors would be required to engage on matters concerning the external audit, and to decide how to vote on the AC report. In addition, the FRC would incur some costs in amending guidance and monitoring compliance with additional provisions in the UK Corporate Governance Code and the Stewardship Code. We believed that these costs were sufficiently low to make further quantification unnecessary.
- 5.81 The costs of the AQR remedy would fall mainly on the FRC. We have not been able to quantify these costs accurately at this stage but would estimate them to be no more than £2 million per year.

5.82 We have sought to avoid creating distortions through remedy design. In particular we gave careful consideration to the scope for distortions to arise from the following elements of the remedy package:

(a) In our desire to promote increased competition in statutory audit, we had regard to the need to ensure that enhanced competition was not distorted towards satisfying the requirements of executive management. We consider that our package of remedies, which includes remedies to promote the influence of the AC and to promote shareholder engagement, will ensure that competition is not distorted in this respect.

(b) PwC cautioned against disenfranchising the AC and shareholders, saying

There is a big difference between remedies that empowered shareholders and the AC as their representative and remedies such as mandatory switching and shorter-period mandatory tendering that would have the opposite effect and disenfranchise shareholders.³⁶⁹

We were aware of the risk of disenfranchising the AC through the introduction of mandatory switching but disagreed that a shorter period for mandatory tendering would have this effect. On the contrary, we considered that going out to tender more frequently puts the AC in a position, in combination with other remedies to enhance the influence and accountability of the AC, to lead the auditor selection process.

(c) We did not consider the other elements of our remedy package to present risks to distortion of competition.

5.83 We therefore concluded that in the light of the design of our remedies the potential for distortion was relatively low.

³⁶⁹ [PwC response hearing summary](#), paragraph 20.

5.84 As set out in paragraphs 5.40 to 5.48 we do not consider that our remedy package will result in the removal of any RCBs.

Comparison of the beneficial and adverse effects of the remedy package

5.85 In weighing up the beneficial and adverse effects of the remedy package, our starting point is that we have assessed the adverse effects, including additional costs, of our remedy package to be relatively low for all remedies other than audit tendering where we accept the costs may be significant.

5.86 In relation to going out to tender every five years, as described above, we think that the direct costs of additional tender processes are likely to be mitigated to some extent by more efficient tender processes and the diversion of marketing activity already undertaken by firms outside of formal tender processes. The effects that we were most concerned with were as follows:

(a) The additional costs on companies, in terms of the opportunity cost of the extra management time that would need to be devoted to running more frequent tender processes. These costs might be more during times of intense corporate activity such as M&A or financial restructuring. We considered that this risk could be substantially mitigated by allowing companies to defer the tender process and explain why they had not gone out to tender for up to two years. We do not consider that companies would incur additional significant incremental costs as a result of our remedy, however the opportunity cost in terms of staff time could be significant for some companies. We have not been able reliably to quantify this cost. As an order of magnitude we would not expect it to exceed £10 million a year.

(b) The potential adverse effects of increased tendering on companies' incentives to run an effective tender process (see paragraph 4.75). We accept that in some instances companies will design tender processes that are more selective and

invite fewer firms to compete in them as a result of a more rigorous pre-selection process. However, we do not consider that there will be a reduction in the effectiveness of tenders because: firms invited to bid will have incentives to compete vigorously; and, alongside other measures we are proposing as part of our package of remedies, the AC will have the influence and incentives to ensure that tender processes are effective.

- (c) The costs of firms in participating in an additional 35 tender processes annually could equate to staff time valued at £12.6–£23.6 million³⁷⁰ a year. We considered this range to be at the upper end of likely actual costs because: (i) we would expect firms to realize efficiencies as a result of more frequent tendering; and (ii) the real opportunity cost of staff time would be lower because tenders were typically held outside of the busy period for audit work. Further, we considered that a significant proportion of this time would be diverted from marketing activity that currently occurs outside of tender processes. On this basis, we estimated the incremental costs to be less than £10 million per year to firms, beyond the transitional period for implementing this remedy.

5.87 The transitional arrangements that we are proposing in relation to the phasing in of the requirement to go out to tender the audit every five years will result in approximately 15 to 17 additional tenders per year on average over the next five years, over and above the additional tenders that will occur as a result of the FRC's transitional arrangements (see paragraph 3.173). This relatively gradual increase in tender activity will ensure that the market has an opportunity to respond and make appropriate adjustments to deal with the increase in tendering activity without causing undue disruption to companies and firms. During this transitional period, the gradual incremental increase in tenders will result in a correspondingly gradual increase in costs.

³⁷⁰ Range based on [redacted] data and in 2005 prices.

- 5.88 We estimate the costs to firms in relation to our audit tendering remedy to be in the order of £10 million a year, with an upper bound of £23.6 million. We accept that for some companies the opportunity cost of staff time in running tender processes will be a significant figure but have not been able reliably to quantify this. We consider that the total costs for companies and firms of this remedy are unlikely to exceed £30 million a year and may be considerably lower than this.
- 5.89 We accept that there are some additional costs associated with more frequent AQR reporting, which we assess at no more than £1.325 million a year (see paragraphs 3.229 and 3.239). We consider that the costs of other remedies are likely to be insignificant in total.
- 5.90 On the other hand, we consider the benefits of our proposed remedy package to be considerable. In our judgement, we think that an increase in competition and a refocusing of competition towards shareholder demand could increase audit quality and thus have important beneficial effects on shareholder value, both in terms of stewardship of individual companies and the broader effects of increased confidence in audit. We place considerable weight on the public benefits for the UK economy. We consider that an audit market in which shareholders have increased confidence will assist in promoting the UK's corporate governance regime as a centre of excellence and will encourage investment in UK companies.
- 5.91 We have assessed the incremental costs of our remedy package, at no more than around £30 million a year, to be modest in the context of the benefits that we expect to achieve. We acknowledge that we are unable to say with certainty by how much our remedy package will improve shareholder value or decrease the cost of capital for UK companies, but the movement only need be very small to have a significant monetary effect, given the sums involved. For illustrative purposes we note that a

1 basis point (0.01 per cent) increase in the market capitalization of the FTSE 350 would represent a benefit to shareholders of approximately £200 million. The annual increase in value that would be required to offset an annual cost of £30 million would be 0.0018 per cent. Further, the benefit to the economy from very small downwards movements in the cost of capital could be considerable. On an illustrative basis, every basis point decrease in the cost of capital could represent an increase in overall market capitalization of around £3.8 billion.³⁷¹ We cannot be precise about the extent of the movement that we would expect to see as a result of our remedy package but we are confident that it is likely to significantly outweigh the costs.

- 5.92 Based on the above assessment we provisionally conclude that the beneficial effects of this package are likely to substantially outweigh the negative effects.

Conclusion on proportionality of the remedy package

- 5.93 We concluded that our remedy package was a reasonable and proportionate response to the AEC that we have provisionally found.

6. Provisional decision on remedies

- 6.1 We have provisionally decided on the package of remedies as summarized in paragraph 5.1.

- 6.2 In our judgement this represents as comprehensive solution as is reasonable and practicable to the AEC and resulting customer detriment that we have provisionally found.

³⁷¹ Based on an initial discount rate of 5 per cent and assuming constant cash flows in perpetuity.