STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of hearing with the Financial Reporting Council held on 29 April 2013

Introduction

1. The Financial Reporting Council (FRC) welcomed the CC's investigation. It wanted to see greater choice in the audit market and felt the investigation would assist the achievement of that objective as well as the objective of increasing competition. It noted that, given its current powers, it did not have the tools or powers to achieve the objective of increased competition.

2. The FRC did not think the proposals in the remedies would necessarily lead to an increase in the number of major players in the market. As a result, it did not think the CC had addressed the risk posed by high concentration in the market and the potential impact of a major firm failing. This had been the FRC's concern from the start of the investigation and it considered that this issue required further thought.

3. The FRC supported the principle of the remedy that strengthened accountability of the auditor to the Audit Committee. It noted, however, that the auditors' ultimate responsibility was to shareholders, not to the Audit Committee. It was quite important to retain that sense of responsibility to the shareholder which should not be diluted, recognizing that although the Audit Committee may be a proxy for the shareholder, it should also be recognized that the Audit Committee was a sub-committee of the board and had responsibilities to the board which should not be undermined in any way.

4. Practically, the FRC did not think the Finance Director (FD) could be entirely cut out of the relationship with the auditor. It was sensible for the auditor to discuss issues with the FD in the first instance. The chances were that the auditor was unlikely to have uncovered some issues except through discussions with the FD or his/her team. The FRC had partially attempted to address this issue with changes it had introduced to the Corporate Governance Code in October 2012, with additional requirements on the company in relation to the coverage of these matters in the Audit Committee's report. The FRC thought that with these changes, the report would also give an agenda to investors and shareholders to discuss matters with the company and/or the auditor. These changes had generated support from investors for regular engagement with auditors.

5. The FRC had also been made aware that the UK seemed to be pushing ahead on its own account with changes in this area and some had raised concerns that there needed to be consistency at an international level. The FRC considered that it was important to play a leadership role in driving the debate as well as promoting as much international collaboration as possible.

6. The FRC thought there may have inadvertently been an oversimplification in the provisional findings of how frequently it inspected the audits of FTSE 350 companies. It tried to identify audits for inspection on a risk basis, which did not lend itself to ensure that all FTSE 350 companies were inspected over a specified time frame. The FRC statutory remit was around the inspection of audit firms, not of entities that were audited. Its approach meant that it inspected some small firms that audited companies outside the FTSE 350. Further, slightly more than 10 per cent of the FTSE 350 was made up of investment trusts which had been attributed a low risk rating. As a result, the FRC devoted more time to inspecting the audits of more substantial and

complex organizations. Also, until recently, there were a number of constituents of the FTSE 350 that it did not have the power to inspect, such as the Crown Dependencies; although it now does have this power.

7. The FRC was keen to engage and explore with the CC how it could increase its transparency from the findings of its inspections, recognizing its confidentiality obligations.

8. The FRC endorsed the proposed remedy on the prohibition of Big 4 clauses.

9. The FRC had significant reservations with respect to mandatory rotation. It did not think it took adequate account of the quality of the incumbent auditor. The FRC's goal was to ensure that companies sought the best auditor for their business. This may be the incumbent auditor. Accordingly, it was nervous about ruling out the incumbent auditor to compete for the work, particularly in the financial services sector, where some auditors may already be holding back because they were heavily engaged with a company in an advisory capacity and so prevented from taking the role of auditor unless they gave up the advisory work. The FRC noted that RSA and Schroders, which had recently tendered, had to manage this issue. The FRC was aware that one or two other companies were having concerns around having a sufficient amount of choice of auditors. The FRC was concerned about limiting the choice of auditors able to take on a job, which would be the result of mandatory rotation.

10. The FRC noted recent developments in Brussels where there had been two votes in the European Parliament. The first by the ECON Committee had rejected the notion of mandatory retendering and the second by the JURI Committee which had called for rotation every 14 years, unless there was retendering at this point, when the contract could be renewed up to 25 years. The FRC did not support the backstop period and it noted that the British Government was also opposed. However, it was unclear what the final outcome of the EU process would be.

11. The FRC favoured mandatory retendering on a 'comply or explain' basis, having just introduced it into the Corporate Governance Code. It noted that since the change, it was aware of 23 companies that had reported that had mentioned the new provision and six of these had provided a date as to when a tender would take place. In the FRC's experience, when it introduced a change to the Code, it achieved approximately 85 to 90 per cent take-up of the provision within one to three years after it came in. The FRC was not keen on retendering being 'mandatory'. It had had a positive experience with the Corporate Governance Code providing leadership in a number of areas using the 'comply or explain' principle, which had then been followed by the vast majority of companies.

12. 'Comply or explain' gave authority to the shareholder, because the shareholder had to decide whether to accept a company's explanation or not. This encouraged more shareholder engagement. It also allowed the FRC to go further than if it were setting hard rules because it allowed companies time to adapt, which tended to lead to them accepting change through the Code more readily. The FRC was concerned that the credibility of 'comply or explain' might be undermined if its changes were now made mandatory, particularly if the changes it had introduced had not been fully established, and, as it believed, it appeared that they would be effective.

13. The FRC asked the CC to take note of what it had introduced in the last few months, which it considered was in the same territory as the changes the CC was proposing, and give those changes some time to work before determining whether they ought to be varied as proposed in the CC's Remedies Notice.

Provisional Findings

14. The FRC considered that it was reasonable for the CC to have made the findings in its provisional findings around the absence of professional scepticism and quality, based on the Audit Quality and Review (AQR) reports that the CC had seen. The FRC considered that there was room for improvement in this area and the findings the CC had made chimed with the anxieties that it had.

15. Some of the changes the FRC had introduced around the reporting by and to Audit Committees were designed to provide a further catalyst to ensure that all the issues that required the auditor to express a judgement were better articulated to Audit Committees, so that Audit Committees could then better articulate them to shareholders.

16. The FRC could not recall an AQR report ever leading directly to a restatement of previously published accounts. It did recall occasions where an AQR report had identified issues around the adequacy of the auditors' challenge of management assumptions, which had led to changes in the subsequent interim or final report. It had also identified corporate reporting issues which had led to better corporate reporting.

17. The FRC considered that the issue of a potential Big 4 collapse and of market resilience in auditing should be a shared responsibility among the profession, government and audit and financial regulators. Whilst it had not been given this responsibility, it had taken a leading role in thinking how to manage this risk. Its responsibility for improving the quality of audit should also reduce the risk of a collapse occurring, although a firm could get into trouble because of non-audit work, which was outside the FRC's scope. The FRC was working with audit firms about plans around contingency planning. The FRC had an established mechanism for early warning of potential issues that a firm might be aware of in its domestic and international network. The FRC aimed to become aware of an issue before it became a crisis and so to create an opportunity to manage that better in order to obtain a satisfactory outcome for the market as a whole. The FRC considered that the Government was aware of the role that it played but did not know if it also had its own procedures in place to become aware of such issues. It did not think the Government would have any processes that would give it better prior warning than it would have.

18. In the event that there were to be a Big 4 firm collapse, the FRC had established a group jointly with government and other regulators to plan and deal with the outcomes from such an event. This involved the Department for Business, Innovation & Skills, successor bodies to the FSA and HM Treasury. Others, such as the Bank of England, may also be requested to participate. The FRC said that it was for the Government to consider, in the event of such a scenario, if it wanted to bail out the failing firm. To date, it had always said no to this and the FRC had no evidence that the Government was reconsidering its position. Secondly, if a collapse were to occur because of reputational issues, existing client Audit Committees would be likely to wish to change the firm as auditors quickly. Partners and staff would also seek an alternative firm. The FRC considered that it would be very hard to prevent this happening. Preventing partners or clients moving would be difficult. In practice, what was likely to happen was an attempt to try and buy a bit of time in order to prevent the unnecessary loss of a firm and, if that was not possible, to arrange an transition.

19. The FRC said that if there was a view that a market with only three large firms would be uncompetitive, then competition authorities making that clear from the outset might assist in slowing down any fallout from one of the Big 4 firms collapsing and increase the possibility of the collapsed entity rising again from the ashes.

20. The FRC did not think, in the event of a collapse, that a firm outside the Big 4 would immediately step up and take the place of the collapsed firm. This was because companies leaving the collapsed firm would tend to look initially to the remaining three large firms to reassure their shareholders that the new firm was the strongest possible.

21. The FRC would need to consider further the possibility of taking on a broader competition duty.

22. The FRC considered that the Public Company Accounting Oversight Board (PCAOB) had much greater resource than it did. It would prefer to have a funding mechanism that the Financial Services Authority had: a straightforward levy. If the work of the AQR team were to be extended, then the FRC thought it would need to enhance its resources. It currently had some concerns about the growing expectations of its work in this area, partly coming out of the Parliamentary inquiries into the financial crisis. It thought there would be an increasing expectation for it to do more and more in this area.

23. The FRC considered that its powers were deficient in a couple of respects at the moment, in relation to its ability to conduct deep investigations into why a company might have failed. It noted that changes coming out of the European Commission proposed changes in which powers were delegated to it and its ability to delegate its powers to professional bodies.

24. The FRC's focus, to try and increase the number of competitors in the market, had been to make sure that the Mid Tier firms were as strong as possible and make that clear to the market. It was partly for this reason that the FRC introduced individual public reporting on a firm-by-firm basis, to counteract any perceptions that only the four largest firms could undertake a FTSE 350 audit.

Mandatory tendering

25. The FRC was intending to publish, in the coming months, a document setting out details of what it had collated of emerging best practice for conducting audit tenders.

26. What the FRC had seen from this exercise so far was the importance of both the company and the bidding firms working out, ahead of participating in the tender, whether firms were capable, on independence grounds, of taking on the work. The FRC was keen to ensure that whatever it published was not seen by companies as the only way to conduct a tender. It wanted companies to continue to exercise judgement and devise a process that was appropriate for them.

27. The FRC considered that it was important for companies to overcome the stigma of putting their audit out to tender. It had been encouraged in this regard by an increasing level of transparency from companies in their annual reports articulating their policy with respect to tendering the audit contract. As a result, the market should not be shocked by the announcement of a tender and investors would have an opportunity to have a say on the issue if they wanted to.

28. Under the new 'comply or explain' provisions, the FRC and, in its view, investors would not find it acceptable if companies were explaining rather than complying with the retendering provision, year after year. They did not expect explanations to be general but to relate precisely to the circumstances of the company at the time. The FRC also expected to see in explanations commentary on how companies intended to meet the requirement to retender in the following year or two years. If explanations

were not of this nature, then the FRC would have to consider whether it needed to tighten up the requirement.

29. The FRC thought explanations of the following type would be acceptable: to do with the commercial strength of the company that made understanding the history of the company important; being engaged in a takeover; no viable alternative auditors at the time; general economic conditions; a change of FD. So long as the company was showing that it was actively seeking to get itself into a position where it could comply, the FRC did not think there was a need to put a cap on the number of explanations that could be provided. The FRC encouraged the CC to see if its 'comply or explain' provisions worked.

30. The FRC considered that 'explanations' were more likely from smaller listed companies than larger ones, possibly because they did not have the resources to make corporate governance changes quickly, or they may in effect have a few very large shareholders (including foreign shareholders) telling them that they were not interested in a particular change. For such circumstances, 'comply or explain' provisions left the decision of compliance to shareholders. If the FRC were reviewing the company's report or accounts generally, it would draw such an issue to the attention of the company, or if the breach of the comply or explain provision appeared particularly bad, to the attention of the Listing Authority, which had the primary regulatory authority to intervene.

31. The FRC landed on a ten year timeframe to retender on a 'comply or explain' basis after consultation. It proposed that a tender should be held after two partner rotation cycles and responses seemed to think that ten years was about the right time period. The FRC thought it sensible to match the rotation period with multiples of the partner rotation cycle. Companies were free to tender earlier if they wanted to. The FRC also wanted to ensure audit quality. There was a risk that if the best partner for the job was not going to be able to serve a full partner term, he may not be put on the job. Multiples of the partner rotation period assisted with the planning horizons of firms which could then allocate resources better. Companies had also expressed a concern about the burden of going out to tender and they were unlikely to be in favour of having to go through a partner rotation and then shortly afterwards having to go through a tender process.

32. The FRC had considered the option of requiring a tender every seven years and synchronizing the partner rotation period to that. It thought, however, that five years was a better and safer period to ensure that partners did not become overly familiar with a firm. It noted that if proposals from the EU adopted different time periods and required 'maximum harmonization', then it may have to reconsider.

33. Since audit tenders had, in the past, been quite rare, the FRC considered that auditors had seen them as significant opportunities and so put a great deal of resource into them. Companies also expected to keep their auditor for quite a long period and so the FRC was not surprised that they specified tender processes quite highly. As tenders became more routine, however, the FRC expected companies not to feel they were making a 'once in a lifetime' type decision and firms would get used to tendering in a much more cost-efficient way. Anecdotally, the FRC considered that this had already begun to take place.

34. In the FRC's view, to ensure that tenders were effective, bidders would need to identify what they perceived as the audit risk—in essence, the outline of the audit plan to be able to demonstrate to Audit Committees that they had *(a)* understood the business risk; *(b)* understood the audit risk; and *(c)* established a plan that adequately tackled these points. Bidders would then need to articulate who was

going to tackle the audit—the lead engagement partner and the immediate team—and who was going to serve in different jurisdictions. Bidders would need to demonstrate the strength of their firm in depth to show who else, besides the lead engagement partner, could step in and what fee they were proposing.

35. In terms of the information that should be provided in an open-book process, the FRC said that companies should provide information about the group structure, what the Audit Committee believed the risks were which could be achieved by sharing the report from the auditors to the Audit Committee or an assessment from the internal audit function of the control environment. The FRC considered it possible to have a sufficiently open-book process for an effective tender without risking the sharing of audit firm proprietary information, although it noted that most firms had a pretty good idea of other firms' proprietary software from due diligence exercises on, for example, acquisitions.

36. The FRC considered that there was a risk if companies asked firms to express views on their existing accounting policies as part of the tender, in that the company may be looking for a firm that accepted policies that might be pushing the boundaries. However, it thought this was a risk in only a small number of cases. Alternatively, companies may be looking to see to what extent the auditor was prepared to challenge. This might provide an opportunity for the auditor to demonstrate best practice picked up from elsewhere and so allow the Audit Committee to benchmark properly.

Mandatory rotation

37. The FRC thought that there was a risk, with a very long tenure, of a loss of independence. Any audit partner would not want to be the one responsible for the loss of a long-standing client. Retendering should provide a solution to this concern, if it became accepted practice that audits did move between firms.

38. The FRC expected Audit Committees to ensure that new partners transitioning in after a partner rotation were sufficiently independent and challenging. Auditing standards and regulations also made the auditing partner personally responsible for the audit and so any professional engagement partner would want to feel comfortable with the position being taken, particularly given the level of independent checking that also went on.

39. The FRC agreed that there was a possibility that if rotation was mandatory, then, particularly in sectors that were currently served by only a few firms, others firms might be incentivized to invest in capability on the basis of an increased chance of winning an audit. This could also alleviate some of the concerns around audit market resilience. However, the FRC was not confident that rotation would create such an incentive, given that there were already some sectors with effectively only two firms capable of doing the audit and other firms had not been incentivized to invest.

Expanded remit and/or frequency of AQR reviews

40. The FRC welcomed any suggestions as to ways in which it might improve its reports to make them more informative.

41. The FRC had recently introduced direct communication with Audit Committees of companies that it reviewed as part of an AQR inspection, on the conclusion of its work. It would also select a sample of Audit Committees to discuss the approach to its inspection before actually starting it. The FRC was limited, due to statutory confidentiality reasons, in making its reports more transparent beyond the company being

reviewed. All significant matters debated within the Audit Committee were now to form part of the Audit Committee report published as part of a company's Annual Report. This, it considered, would give some indications about the quality of the audit undertaken.

42. The FRC selected which audits it would review based on a risk assessment. The risks it would consider included: those arising due to the economic circumstances of the company generally (so in recent years, banking had featured largely in its choice of sector); whether there had been any pointers of change within a company (these might be large movements in the share price, a takeover etc); and whether there were particular concerns with the audit firm (eg poor inspections the previous year). The FRC also wanted to get a reasonable range of coverage of the listed market over a reasonable period of time.

43. The FRC accepted that its selection approach might not be the most helpful to shareholders in terms of allowing them to compare performances across the piece and make an informed choice, because its reviews did not have an even coverage. Coverage was broadly even across the largest firms but given the arrangements established through the Companies Act, it was not possible to achieve an even coverage where firms audited relatively few entities. However, it noted that the objective of its inspection regime was designed to assess quality; it was not designed to increase competition. The FRC also noted that its process had a cascade effect within firms, and issues identified in audits it did review were cascaded more widely within the firm.

44. The FRC acknowledged that its policy to review firms outside the Big 4 less frequently might contribute to the perception that they were of a lesser quality. However, it was difficult to change this approach because these firms, particularly below BDO and Grant Thornton, audited so few public interest entities. The FRC took the view that its ability to influence audit quality, in line with its primary objective, was better focused on reviewing those firms that audited public interest entities. To tackle other issues, it would require additional resources.

45. The FRC said that over the last three to five years, in the audits of FTSE 350 companies, there was very little difference between the grades of the Big 4 and the next firms down. However, it noted that there were very few FTSE 350 entities that were audited outside the Big 4 firms and hence not many AQR inspections of such audits.

46. The FRC considered that its reviews already captured wider aspects of audit quality, beyond just technical compliance with auditing standards. It focused on key judgements. It had also introduced this year thematic reviews looking at specific areas of an audit. This would cover a range of firms and examine how each one dealt with particular issues. Areas might include materiality, compliance with rules, regulations and fraud. The FRC also had fairly regular discussions with ACCs on a generic basis, seeking their input on how it could enhance its AQR process and reporting. It had also from time to time issued questionnaires to ACCs. It did not, however, speak to company management about its inspection process. The FRC spent a considerable amount of senior resource to try and ensure that its reports were as consistent as they could be. To do that across a wider pool would require additional resources.

47. The FRC considered that the PCAOB's output, compared with its own, was much less transparent in terms of public reporting. In relation to the audit inspection process, it worked jointly with the PCAOB and the PCAOB had been inspecting the UK work in relation to US listed companies. The FRC understood that the PCAOB was satisfied with the quality of inspection in the UK.

48. The FRC thought that its and the PCAOB's processes increasingly converged. They undertook joint inspections, compared notes on an international basis and ran global training programmes together. The FRC noted that the PCAOB's UK inspections tended to be conducted in shorter time frames. This was partly because of travelling commitments. The PCAOB also tended to start its process with an interview of the partner first and work out from there to a review of the files. The FRC tended to work in the opposite direction. The FRC had the impression that firms preferred the PCAOB's approach. The PCAOB's reports also tended to come out about a year later than the FRC's. The FRC noted that inspection regimes internationally all had the same objective of trying to improve audit quality.

49. The FRC was able to challenge the accounting treatment reached by an auditor. It did this in close liaison with its corporate review reporting team to look at issues more holistically. The FRC said that there may well have been instances when, following an inspection, companies had changed an accounting treatment in subsequent periods. The FRC's work on companies' compliance with accounting standards was undertaken through a different team which specifically had the powers to require companies to make restatements. The FRC was aware of a number of examples when following the challenge of a particular judgement; eg a company had changed the way in which it treated a provision in the next reporting period ([✂]). The FRC said that firms were unlikely to admit that the change was in response to its challenge, which would be tantamount to admitting fault, but would say instead that it just reflected a change in circumstance.

50. The FRC had delegated its firm-wide review function of firms that audited fewer than ten companies in its scope to the relevant recognised supervisory body (RSB). Findings from these bodies did not feed back into its annual AQR report but did feature in its report to the Secretary of State. It continued to look periodically at the individual engagements of these firms although, going forward, its plans were to delegate the review of some individual engagements to the RSB's as well. This, however, would not include any FTSE 350 audits.

Prohibition of Big-4-only clauses in loan documentation

51. The FRC supported the prohibition of Big-4-only clauses in loan documentation; although it had not seen much evidence that they had significant effects in the market.

Strengthened accountability of the auditor to the Audit Committee

52. The FRC said that it was too early to see how its new requirements for Audit Committees to make disclosure in the annual accounts were driving behaviour. It thought the need to report would drive better behaviour. It hoped that this change would encourage all Audit Committees to achieve the standards of the best committees: to challenge management around the assumptions they were making and reporting comprehensively on the most significant risks the company was facing; and being open to challenge from the auditor. One way in which the FRC thought investors could distinguish the best and worst was from looking at the Audit Committee report within the published Annual Report and to question ACCs based on that. The FRC was concerned about the historic lack of investor engagement with the Audit Committee.

Enhanced shareholder–auditor engagement

53. The FRC said that audit firms had told it that they would report more openly, with less attention to their own risk of being sued and of greater benefit to investors, if their liabilities were reduced. Investors were not demanding this change because they did not believe it would lead to any changes in the way auditors reported, so there did not seem to be any political will for this change to be made. The FRC also considered that the changes to the reporting in the Audit Committee report somewhat bypassed this problem. The Audit Committee report was a report of the board and directors were more protected, in terms of liability, than auditors were. They were also appointed by shareholders and so it was more appropriate for them to report to shareholders through this report rather requiring the auditors to report to shareholders, through the audit report.

54. In relation to selection of the auditor, the FRC favoured early engagement with shareholders on this issue. The FRC considered that shareholders would expect the board to reach a judgement on what was ultimately the best way forward.

Non-audit services

55. The FRC was contributing to discussions taking place in Europe on the extent of non-audit services an auditor could provide. It seemed clear that the likely outcome of these discussions was an increased number of prohibited services. The debate was currently around what constituted an audit-related service and limits around those. The FRC's view was that if it was an audit-related service, which naturally fell for the auditor to do, then there should not be any cap around those, otherwise inefficiencies for companies would be introduced.