Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

By e-mail: auditors@cc.gsi.gov.uk

Date: 20 March 2013

Dear Ms Carstensen

GC100 response Competition Commission – Statutory Audit Services Market Investigation

I am writing on behalf of the GC100 to respond to the Competition Commission's recent investigation into the Audit Services Market. We note that you have requested responses both to your provisional findings and to the possible remedies. This response is intended to respond to both papers. GC100 is the association for the general counsel and company secretaries of companies in the UK FTSE 100. There are currently over 120 members of the group, representing some 80 companies. Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

General Points

The Financial Reporting Council has recently updated the UK Corporate Governance Code to require companies to tender audit services every 10 years on a "comply or explain" basis. We believe that these changes should be allowed time to take effect before introducing any further changes.

We note the provisional findings from your review, many of which are very similar to the experience companies have when assessing the quality of work and service levels from an incumbent supplier against that of an alternative supplier. However we do not understand how the proposed remedies are intended to address these findings.

We believe that your findings and proposed remedies do not take account of the importance and strength of the Audit Committee, which acts on behalf of shareholders in this area.

Response to Provisional Findings

1. Companies face significant hurdles in comparing the offerings of an incumbent firm with those of alternative suppliers other than through a tender process

We agree that it is much easier for companies to assess the service levels provided by the incumbent firm rather than that provided by alternative suppliers. However, this is the case with any other service provider engaged by the company.

Whilst management may only be familiar with the service levels provided by the company's auditors, most Audit Committee will comprise experienced experts who are familiar with other audit firms used by other companies where they hold executive or non-executive positions. In that respect, Audit Committees are in an excellent position to assess service levels provided by non-incumbent firms, indeed they are better placed than management to make these judgements because of their current and comparative experience when selecting other service providers.

In addition, there is actually more information published by regulators such as the Financial Reporting Council and the Public Company Accounting Oversight Board on audit service levels than is generally available for other service providers.

2. It is difficult for companies to judge audit quality in advance due to the nature of audit

We agree that it is difficult to judge audit quality in advance but again this is the case with any other service provider and Audit Committee members are likely to have experience of other audit firms and from information published by regulators.

3. 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

Whilst we would also agree that the relationship of mutual trust and confidence is important both to companies and auditors, and indeed is crucial to an effective audit, this again is something that would apply to the relationship with any other service provider. Such mutual trust and confidence is eroded should a company experience poor performance or an uncompetitive price. However, this is exactly why the role of the Audit Committee is crucial as the Audit Committee's independence ensures that any mutual trust and confidence built up between auditor and company does not jeopardise auditor independence.

4. Company management face significant opportunity costs in management time involved in the selection and education of a new auditor

We agree that the management time involved in selecting and educating a new auditor is probably one of the biggest factors that discourages companies from changing auditors.

However again Audit Committee members are typically experienced in such tenders from other experiences either as non-executives elsewhere or from previous careers as executives or professional advisers or auditors. In practice well planned tenders need not be unduly expensive or disruptive for all parties. The main reason long lived audits exists is because of satisfaction with the service provided just like any other service.

Members who have been through a tendering process recently have confirmed that the process involves substantial management time, particularly in the transition period between audit firms. In the case of large groups in numerous jurisdictions, with multiple subsidiaries, this transition period can be as long as a year, during which time the outgoing auditor needs to co-operate with the incoming auditor. It is therefore critical that corporates have an effective, efficient and focused process they can utilize. This remains an issue whether companies wish to switch to another "Big 4" firm or to a mid-tier firm.

In the early years following the appointment of a new audit firm, there is an increased risk of a reduction in the quality of the audit service, as the new firm needs time to build up a comprehensive understanding of the company and its issues. The risks associated with mandating audit change at every company in the FTSE 350 over too short a timeframe are therefore high. These risks are likely to far outweigh those of the current situation where it appears a few companies, or in extreme cases, sectors, have governance failings. We believe that these failings can be addressed by the Financial Reporting Council's changes already in place.

5. Mid-Tier firms face experience and reputational barriers to expansion and selection in the FTSE350 audit market

We feel that one of the biggest barriers to selecting a mid-tier firm as external auditor is their ability to provide the services that are needed by a large complex international company. Most of our members have operations in many different jurisdictions and would have concerns regarding the ability of smaller firms to have the international expertise, scope and resources to handle such large audits on an international basis. Members have also found that the Big 4 firms generally have a deeper understanding of specific industry matters. Members who have been through a tendering process recently have found that mid-tier firms find it difficult to compete with the "Big 4" in terms of expertise, level of resources and global coverage and either decline to tender or recognise that they fell short in the process.

We do not believe that any of the proposed remedies address this key issue.

6. Auditors have misaligned incentives as between shareholders and company management and so compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ

This is not the experience of Audit Committee chairs and members in the top 100 companies. We would suggest that what is described might have been the case 15-20 years ago but Audit Committee competence and authority has developed significantly in recent years and we do not today recognise the description you give.

The role of an effective Audit Committee is to prevent this situation. There are a number of safeguards in place to ensure that the auditors are independent of management:

- There are strict rules in place regarding the ability of the external auditors to undertake certain non-audit services. The company's auditors give up the opportunity to provide more lucrative non-audit services to comply with these rules to ensure that independence is maintained.

- Most non-audit services are either prohibited or require the approval of the Audit Committee or its Chairman.

- Most Audit Committees hold private sessions with the external auditors without management present on a regular basis. Any concerns that the auditors may have can then be raised.

- The regular rotation of audit partners every 5 years combined with regular rotation of senior audit staff also supports an independent and robust audit. In all cases, the new audit partner and key members of the audit team meet with the Audit Committee before appointment to ensure that their appointment is matter for the Audit Committee and not management.

If these safeguards are not properly enforced, it is a failure of corporate governance within the company concerned and not merely a question of auditor independence.

Moreover, in our experience, auditors are sensitive to the need to protect their reputation and therefore highly incentivised not to risk that reputation by failing to fulfil their role properly. Such failings can lead to professional disciplinary proceedings and serious sanctions, which may include withdrawal of the right to practise.

7. Auditors face barriers to the provision of information that shareholders demand (in particular from the reluctance of company management to permit further disclosure.)

In our experience, we have received very little interest from shareholders for further information relating to audit work undertaken. Ahead of our Annual General Meetings, we receive very few comments or questions relating to audit work, other than the level of audit fees paid or the length of tenure of our auditors. Shareholders rarely ask to meet with the Chairman of the Audit Committee or raise questions about the audit in meetings with management.

We do not feel that the quality of audit reporting to holders is solely driven by the reluctance of management to permit greater detail. In fact, much of the audit reporting is driven by prescribed language in auditing standards. Reluctance to go beyond this is therefore less about management than about audit firms seeking to mitigate risk by adhering precisely to what they must say – rather than making subjective statements. It would seem unlikely that mid-tier firms would approach this challenge any differently. If it is felt that there is an information gap in terms of disclosures, this could be better deal with by amending those auditing standards.

Response to Possible Remedies

1. Mandatory Tendering of the Audit on a more frequent basis

We support the provision in the recently revised UK Corporate Governance Code that the external audit contract should be put out to tender at least every ten years on a comply or explain basis and believe that this new regime should be allowed to operate for a few years before any further changes are made.

We believe that the ten year period is about right, given the work involved both for the company and for the auditor and prospective auditors both in the tendering period and

should a change of auditor be the outcome, in the early years of educating the new auditor about the company.

We also believe that it is important that the "comply or explain" basis is retained as there could always be some intervening event that makes it inadvisable to tender the audit in year ten, for example when there is a new Chief Financial Officer, new Chairman of the Audit Committee or takeover activity.

We do not however understand how tendering the audit every 10 years necessarily increases the likelihood of more mid-tier firms being appointed auditors to FTSE350 companies. We further believe that mid-tier firms are put off tendering for FTSE350 contracts because of the time and resources required both during the tendering process and immediately after appointment.

2. Mandatory Rotation of Audit Firm

We do not support mandatory rotation of audit firms. Audit Committees will wish to appoint the best firm for their company having conducted a formal tender process and if that happens to be the incumbent auditor, it makes no sense to appoint an alternative given the length of time and resources required in the early years following a new appointment. The proposal also undermines the role of the Audit Committee which as noted above has developed hugely in recent years and which now is the dominant influence in tendering decisions.

For many FTSE 350 clients, there may well be a limited number of audit firms who could be considered for appointment as the company's auditors. Firstly, a company needs to be certain that the proposed auditor has the expertise, experience, size and international scope required to handle the particular audit. However, there are further considerations, which are also relevant. A company would not wish to appoint an external auditor which:

- Undertakes extensive non-audit services for the company because of the need not only to tender and change the provider of audit services, but also to tender the non-audit services currently provided by the new auditor.

- Has close links with a key member of financial management or the Audit Committee.

In some cases, a company may also not wish to appoint an auditor which acts as auditor to a major competitor.

We believe that mandatory rotation of audit firms diminishes the authority of the Board to manage the Company's affairs. There is no evidence from the very limited application of automatic tendering in other countries that it has done anything for audit quality. In fact it could well undermine quality because of the lack of motivation in later years of the appointment and because it takes time for a new auditor to get up to speed particularly in complex groups.

3. Expand remit and/or frequency of Audit Quality reviews

We do not see the need to expand the role and frequency of Audit Quality Reviews although we would note that the current 1 year data gap for information on mid-tier firms is not conducive to opening up the audit service market to mid-tier firms. We understand that

the Financial Reporting Council has inspected the Big 4 firms on an annual basis, whilst the mid-tier firms are only inspected on a three-yearly basis. Perhaps this is something that could be reviewed when the inspections are delegated to the professional bodies subject to oversight and supervision in April.

4. Prohibition of "Big 4" clauses in loan documentation

We would not object to the removal of "Big 4" clauses in loan documentation, although we do not see that this would necessarily make a significant difference as to whether or not a company will decide to appoint a mid-tier firm. The decision to appoint a mid-tier firm will depend on their ability to conduct an audit of the complexity and scope required.

5. Strengthened accountability of the external auditor to the audit committee

We would refer back to our response to Provisional Finding 6 above. Most Audit Committees do hold regular meetings with the external auditors without management present and have strict policies in place regarding the provision of non-audit services by the external auditors. A responsible Chairman of an Audit Committee is actively involved in the relationship with the external auditor, as described in your paper.

Whilst we recognize the importance of the points made in your paper, we do not understand how strengthening the accountability of the external auditor to the Audit Committee addresses the issue of expanding the audit service market to mid-tier firms.

6. Enhanced shareholder-auditor engagement

We do not support the recommendations within this remedy. Shareholders appoint the members of the Board and delegate to them authority for running the company in the long-term best interests of shareholders as a whole. This includes deciding whether and when to tender audit services. In turn, the Board select members of the Audit Committee, who are responsible for overseeing, amongst other things, the audit.

It is not appropriate that more than as simple majority be required for re-electing an auditor beyond any period of mandatory tender, when a simple majority is all that is required for appointing a director.

We see little purpose in requesting the audit partner to present at the AGM. Auditors are currently present at all AGMs and available to answer questions. In practice however, this rarely happens. Requiring auditors to make a presentation would extend the AGM unnecessarily.

Shareholders already have the right to raise questions on the audit and financial reporting at the AGM and this right is rarely exercised.

7. Extended reporting requirements

We see no need to extend reporting requirements further. Every other consultation on narrative reporting exhorts companies to "cut the clutter" and requiring additional disclosure runs counter to the current trend, particularly as we have seen little demand from shareholders for further information. We suspect that any further disclosure requirements would merely lead to unhelpful boilerplate disclosure.

We do not understand how extended reporting requirements would serve to facilitate greater use of mid-tier firms.

We would welcome the opportunity to discuss these issues with you further.

Yours faithfully

Mary Mullally
Secretary, GC100
0207 202 1245