



**BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY**

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Inquiry Manager  
Statutory Audit Investigation  
Competition Commission  
Victoria House  
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Dear Sir or Madam

**Statutory audit services market investigation - Provisional decision on remedies**

We have read with interest the Commission's provisional decision on the remedies to be applied following your investigation into the statutory audit services market.

Our interest in the statutory audit services market relates primarily to audit quality; it is of fundamental importance to our supervision of firms and to financial stability generally that the financial statements of the firms we supervise are the subject of high-quality audits. We could not support proposed remedies that put that audit quality at risk, regardless of the benefits they might bring more generally to the competitiveness of the statutory audit services market.

It is against this background that we comment on one aspect of the provisional remedy package: the suggestion that FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. We are comfortable with there being a mandatory tendering requirement. However, a tendering process every five years would in our view put audit quality amongst the larger firms that we supervise at risk. The reasons we believe this would be the case are as follows.

- Five years will in practice allow insufficient time for a firm to judge the quality of a new auditor's work - so tenders would be won and lost for other reasons – and will create undue distractions for auditors of big complex firms.

The audits of the UK's biggest banks and insurers are amongst the most complex audit assignments in the UK. The audit tendering process for such firms will be a long and involved process; judging by the recent and on-going tendering processes for HSBC and Standard Chartered bank (SCB), it can be nearly two years from starting the tendering process before a new audit firm starts its work. Furthermore, taking on the audit of one of the UK's biggest banks or insurers is also a long and involved process; even the best and most diligent auditor can take a couple of years to understand fully and respond appropriately to the risks of these complex, diverse businesses.

Thus, with a mandatory tender process every five years, a new auditor would complete only three statutory audits before the tendering process would start again and in any case for two of those audits the new auditor will have been getting up-to-speed.

- We believe there is a significant risk that the auditor will not be fully incentivised in that third year - the first year it is fully up-to-speed but also the last year before the tendering process will take place - to challenge management and, when appropriate, to sustain that challenge. In the absence of such incentives, we fear audit quality will suffer.

- We question whether holding a tendering process when the auditor has delivered only one up-to-speed audit will achieve the improvements in competition that are envisaged.

Furthermore, for an existing auditor, a mandatory tender process every five years means a substantial distraction whilst working on a re-tender will arise every five years. If the tender process coincides with the change of lead partner, it might not be a substantial distraction for the potential new leader partner but it will be for some other senior members of the team. Such a distraction puts audit quality at risk.

- There is only a small pool of people with the expertise, experience and personal characteristics needed to deliver high-quality audits of the UK's biggest banks and insurers, and tenders every five years risk both over-stretching the existing pool of people and damaging the development of further (or replacement) experts.

In our experience, the lead partners and other key personnel on the audits of the biggest UK financial institutions need to have expertise and experience that can be developed only as a result of years of nurturing. There are only a small number of such people at the moment. The Commission has made it clear that it expects audit firms to take tender processes seriously. That means putting their best people on the tender team. As a result, that small population of people capable of running high-quality audits will need to be increased in size so that there are sufficient people both to lead tenders and run big firm audits. Increasing the number of these people is not something that can be done quickly. The Commission acknowledges (in paragraph 3.117(b)) that five year mandatory tendering might cause a short-term capacity issue, but the time taken to develop more people is sufficiently long that capacity will also be an issue in the medium-term if audit quality is to be maintained.

The Commission's paper does not discuss the implications of mandatory audit tendering every five years for succession planning. We suspect that one consequence of the greater uncertainty five year mandatory tendering will cause is that the succession planning will require a much greater commitment and investment - by both the audit firms and the individuals concerned - than in the past. If that is the case, the current lack of capacity - and its implications for audit quality - could be a much longer-term issue.

These capacity issues are a serious concern for us because of their potential implications for audit quality.

We recognise that the Commission is also proposing that firms should be permitted to defer a mandatory tendering process by up to two years if there are exceptional circumstances. However, the Commission has also made it clear that the 'exceptional circumstances' it has in mind relate to the occurrence of major transactions, significant management changes or other disruptive events rather than concerns about the impact a tendering process would have on audit quality. As such, this relief would appear not to address our concerns.

We therefore ask the Commission not to implement its mandatory tendering requirement with a five year period. If audit quality is not to be put at risk, the period needs to be several years longer and perhaps as long as the 10 years that is the newly-established current best practice in the UK.

Finally, we think the current tendering processes within the large UK bank sector might provide some useful insights into the veracity of some of the comments made in the paper about how the various stakeholders are likely to behave in practice. Therefore, if the Commission has not done so already, we suggest it seek to understand the strategies adopted and the reasons behind those strategies. I hope these comments are useful to you. If you have any questions about the comments or our views on alternative remedies, please do not hesitate to contact either me or Paul Ebling.

Yours faithfully



Paul Sharma  
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