FURTHER COMMENTS OF BDO ON THE PROVISIONAL DECISION ON REMEDIES (PDR) REGARDING MANDATORY TENDERING

1 THERE IS NOT A BINARY CHOICE BETWEEN 5 AND 10 YEARS

There is not a binary choice between mandatory tendering every 5 years and tendering on a "comply or explain" basis every 10 years. The implication of Deloitte's response is that because few respondents favoured mandatory tendering every 5 years, the CC should endorse the Code; but several respondents, including BDO, supported mandatory tendering every seven years.[1] We note that BlackRock recommends a minimum period of seven years between tenders. The frequency of AEP rotation should also be considered in this context.

2 PROPOSED REFINEMENT OF REMEDY 1

2.1 Several of the critics of the CC's proposal for mandatory tendering every five years claim that:

(a) the tender process will be devalued (to a "box-ticking exercise")[2] because companies will not want to switch auditor every five years; and

(b) the incumbent auditor has a significant advantage in tender situations[3] and the prospects of another firm winning a tender will be insufficiently high to justify other firms incurring bid costs in relation to that tender, which will weaken competitive pressures.

2.2 BDO considers that Remedy 1 could and should be refined to address these concerns, while still achieving the CC's legitimate objectives.

2.3 One key issue is the timing of the first round of tenders ("**T1**") under the CC's remedies package. Given the low level of tenders and switching in this market, even with the adoption of the revised Code, the CC should resist attempts to defer implementation of T1 (e.g. by requiring tenders only every 10 years). The claim that the tender process will be devalued should not apply to T1. Indeed, the validity of that claim depends on whether companies are considered likely to switch after a tender. Critics of Remedy 1 generally state that tenders under the Code have been meaningful and rigorous processes; but there is no good reason why T1 should be any less meaningful or rigorous, merely because those tenders would happen sooner than they would otherwise do under the Code. Critics of Remedy 1 generally accept that Audit Committees are effective custodians who take their duties seriously. On this basis, T1 should be meaningful and rigorous. The issue, therefore, is not the timing of T1, but the frequency of subsequent tenders.

2.4 BDO therefore suggests that the CC refines remedy 1 so that tendering would be mandatory every five years, but if a company switched auditor following a tender (whether at T1 or subsequently) it could then wait seven years before conducting the next tender for its audit (and this could be deferred for up to two years in appropriate circumstances). T1 would therefore take place as currently

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[1] See, for example: (i) the responses of BDO, Mazars, Nestor Advisors, Chartered Financial Analyst Society of the UK and National Association of Pension Funds to the CC's Notice of Possible Remedies, and (ii) the CC's summary of calls held with case study Company W.

[2] See, for example, EY response to PDR, paragraph 3.29 and KPMG response to PDR, paragraph 1.12.

[3] See, for example, PwC response to PDR, paragraph 14; KPMG response to PDR, paragraph 3.3.15; EY response to PDR, paragraph 3.18(b)(ii).

contemplated; when subsequent tenders would take place would depend on whether a company switched auditor.

2.5 This refinement of Remedy 1 would:

(a) incentivise companies to switch auditor, without making it mandatory to do so, thereby preserving choice but addressing incumbency advantage, because:

(i) a new auditor would be in place for seven years, which would give it plenty of time to familiarise itself with the company's business and the company the confidence that it would not have to start looking for an alternative auditor not long after its new auditor had got "up to speed"; and

(ii) the company would be able to defer the costs and disruption of a tender process for at least two years if it switches auditor, effectively to compensate it for any costs and disruption incurred in making that switch;

(b) incentivise non-incumbent firms to bid for tenders, because they would:

(i) if successful, expect to have seven years business rather than five, so could recoup tender costs over the longer period; and

(ii) know that companies would benefit from switching to them by deferring tender costs and disruption by up to two years, which would counterbalance the disruption caused by switching auditors, and therefore increase their prospects of winning the tender;

(c) reduce the potential number of first year audits being conducted at any one time, as those are generally accepted to require more "learning time" for the auditor and more resourcing by both auditor and company;

(d) increase the chances that a five yearly AQRT review of the audit would have been conducted following a switch of auditors, thereby enabling the audit committee to make a more informed assessment of audit quality before conducting the next tender;

(e) allow audit committees more discretion than they would be permitted under the present Remedy 1; and

(f) reduce resourcing demands and bid costs for both companies and audit firms, thereby making the remedy more proportionate, while achieving the same benefits as Remedy 1.

2.6 These factors would combine to increase the competitive pressures at tendering and increase companies bargaining power, as compared with the current Remedy 1 proposal, because the revised Remedy 1 would not reduce choice or risk tenders becoming "expensive compliance exercises".

2.7 AEP rotation requirements could be aligned with these five and seven year periods, so that if a new firm were appointed after a tender, the AEP could remain in place for seven years. For reappointed incumbent firms, AEP rotation would occur after five years, again in line with the tender cycle.

3 FOUR IS NOT ENOUGH

Several of the issues alleged to arise from the introduction of mandatory tendering every 5 years stem not from that remedy, but from the existing lack of choice in this market: these include the need for prospective auditors to identify and clear conflicts of interest, including provision of non-audit services. The CC's package of remedies should lead over time to choice between more than four firms, thereby ameliorating those concerns. Nevertheless, a statement from the CC acknowledging the existing lack of choice in the market would be welcome, helpful and appropriate.

4 CAN AUDIT FIRMS PASS ON INCREASED COSTS?

Along with other Big Four firms, EY suggests[4] that the proposed remedy will "*likely lead to higher audit fees as the additional costs to audit firms are passed on to companies in whole or in part.*" This appears inconsistent with claims by the Big Four that companies have significant bargaining power and exert considerable downward pressure on audit firms' prices[5]. However, even if EY's suggestion is correct, revising Remedy 1 as proposed above should ameliorate any such increases to a considerable extent.

5 THE CODE IS STILL NOT ENOUGH

The revised Corporate Governance Code is merely increasing switches among the Big Four. It does not address the significant barriers to entry and expansion which the CC has rightly identified. Remedies 2 to 7 will not, in our view, address all the issues identified by the CC without mandatory tendering. A revised Remedy 1, together with Remedies 2 to 7, would do so.

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4 EY response to PDR, paragraph 1.3(a)(ii); see also KPMG response to PDR, paragraph 1.16.

5 See, for example, EY response to PDR, paragraph 2.1(a).