

COMMENTS OF BDO LLP ON THE CC'S PROVISIONAL DECISION ON REMEDIES

1 OVERVIEW

BDO welcomes the CC's Provisional Decision on Remedies (PDR). The proposed package of remedies is appropriate, proportionate and should remedy (or at least go a long way towards remedying) the AECs which the CC has rightly identified.

2 REMEDY 1 - MANDATORY TENDERING

2.1 Mandatory tendering every five years

2.1.1 BDO welcomes this proposal and commends the CC for recognising that the recent changes to the UK Corporate Governance Code do not go far enough.

2.1.2 BDO has no reason to believe that a mandatory tender process – as opposed to the current process based upon the 'comply or explain' principle – will not be taken seriously by both companies and auditors: indeed, to the extent that there is a serious approach already being taken to retendering, BDO believes that the introduction of a process backed up by the force of law will only reinforce the current approach, rather than undermine it.

2.2 Tender process

2.2.1 If the AECs which the CC has rightly identified are to be addressed, it is necessary to ensure that tenders for statutory audit services to FTSE 350 companies are not simply confined to the Big Four.

2.2.2 AEP rotation dates are not necessarily in the public domain. The incumbent auditor has an informational advantage in this respect. FTSE 350 companies should therefore be required to publish in their annual reports when the next tender for the company's audit is expected/intended to happen. This would reflect increased shareholder engagement, be consistent with the "comply or explain" exception and allow all audit firms, including Mid-Tier firms, to identify and act on appropriate tender opportunities. This would have minimal cost implications and could be cheaper than requiring companies to advertise tenders or announce them on a third party website.

2.2.3 BDO agrees that new entrants to the FTSE 350 should be subject to the proposed Order immediately upon entry to listing.

2.3 Open book

BDO considers that the information to be provided to bidders in connection with a tender should include (in addition to the information listed by the CC at paragraph 3.145) all information provided to the Audit Committee by the incumbent auditor in relation to the audits for the last three years.

2.4 Timing of Implementation

2.4.1 BDO agrees that the CC should implement this remedy by Order.

2.4.2 In BDO's view, serious consideration should be given to whether the draft Order:

- (a) will be in an appropriate and sufficiently consensual form for it to be realistic for it to be fast-tracked for a commencement date of 6 April 2014; or
- (b) falls within a class of exemptions to the common commencement regime and, if so, whether it should be brought into force as and when it is ready, rather than waiting for the next common commencement date.

2.5 **Transitional Provisions**

2.5.1 The CC proposes (at paragraph 3.172(b)) that *"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."* However:

- (a) It is not clear what constitutes "tendering" since 1 January 2005 for this purpose. For example, would a private, informal, non-transparent process involving only two audit firms, culminating in the retention of the incumbent auditor, be sufficient for this purpose?
- (b) Which part(s) of a tender process needs to have taken place since 1 January 2005 to qualify for deferral? For example, if the new contract was entered into on 1 January 2005, but the invitation to tender, preparation and submission of tenders and award decision all took place before that date, does it qualify?
- (c) No mention is made of a cut-off date for such tenders. If no tender process has begun by a specified date (such as the date of publication of the CC's final report), FTSE 350 companies should not be able to evade the spirit of Remedy 1 by running a last minute "quick and dirty" tender in order to postpone the obligation to conduct a proper tender for their audit.

2.5.2 In other words, transitional arrangements need to be clearly defined and include anti-avoidance provisions.

3 **REMEDY 2 – AQR**

3.1 **Frequency of reviews**

BDO agrees with the CC's proposals on frequency of review, including equal frequency of reviews for major firms.

3.2 **Costs**

In considering the costs of its proposed remedies (see, in particular, paragraphs 3.230, 3.240 and 5.81), the CC should also take into account the costs to Mid-Tier firms of increasing the frequency of AQR reviews for Mid-Tier firms from every two years to every year. This remedy will mean that more time (in particular audit partners' time) has to be spent by each Mid-Tier firm in preparing for and dealing with an increased number of AQR reviews. On the basis that an extra 5 to 6 of BDO's audits would have to be reviewed each year, BDO considers that its annual extra costs (comprising extra time for the relevant audit engagement partner and audit manager on each extra audit file reviewed, plus additional technical resources) would be, at a conservative estimate, approximately £250,000 per year. BDO anticipates that GT would also face similar costs, while costs for other Mid-Tier firms would be lower, as those firms conduct fewer FTSE 350 audits.

4 **REMEDY 3 – BIG 4 ONLY CLAUSES**

4.1 **Scope of Order**

4.1.1 BDO welcomes the CC's provisional view that an Order should prohibit 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.

4.1.2 BDO agrees that this prohibition should apply:

(a) to all companies whose accounts must be audited in accordance with Part 16 of the Companies Act 2006, not just those companies in the FTSE 350; and

(b) only to relevant provisions of the relevant arrangement.

4.1.3 BDO considers that the prohibition should apply to existing loan agreements, subject to a transitional period. Otherwise, companies with existing long term lending arrangements (or which renew or extend existing agreements) could be prevented from moving to a Mid-Tier auditor when their audit is put out to tender under Remedy 1, which would restrict the effectiveness of Remedy 1 and cannot be what the CC intends.

4.1.4 BDO therefore suggests that the prohibition applies to loan agreements entered into on or after the commencement date of the relevant Order or which have effect after a specified date, which could be set by reference to the transitional arrangements for Remedy 1.

4.1.5 BDO welcomes the CC's proposal to include a reporting requirement in the Order to the effect that no loan agreement has been entered into which is contrary to the prohibition.

4.2 **Implementation**

See 2.4.2 above regarding the timing of implementation.

5 **REMEDY 4 – ENHANCED SHAREHOLDER ENGAGEMENT**

5.1 **Recommendations**

5.1.1 BDO welcomes the CC's proposed recommendations, including in particular the introduction of an advisory vote for shareholders on the sufficiency of disclosure in the Audit Committee Report. This should encourage the adoption and enhancement of best practice on disclosure across listed companies, particularly if investors monitor and compare disclosure by different companies.

5.1.2 BDO welcomes the CC's proposed recommendations for revisions to the UK Corporate Governance Code and the Stewardship Code, save that the CC's proposed amendments to Principle 4 of the Stewardship Code (set out in paragraph 3.346) refer to the Audit Committee chair and members as part of "*management*", which is not entirely correct, as they are non-executive directors with an important but different role from executive management. It would therefore be better to add a new bullet point to Principle 4, to read:

"holding additional meetings with the Audit Committee to discuss concerns;".

5.1.3 BDO considers that the advisory vote on the Audit Committee Report should concern the **content** of the Audit Committee Report, not just the “*sufficiency of the level of detail in the Audit Committee Report*” (see paragraph 3.365). In other words, shareholders should vote on whether the substance of the report is acceptable, not merely whether it is sufficiently detailed.

5.1.4 BDO agrees that the CC’s recommendations should apply to all companies with a Premium Listing, not just to FTSE 350 companies, given the wider importance of good corporate governance.

5.2 Remedies not pursued

BDO understands the CC’s reasons for deciding not to pursue the Tender Voting Remedy or the Enhanced Voting Remedy.

5.3 Implementation

BDO welcomes the CC’s proposed implementation date of 6 April 2014 for Remedy 4.

6 REMEDY 5: STRENGTHENING ACCOUNTABILITY OF EXTERNAL AUDITOR

6.1 Proposed Order

BDO welcomes the CC’s proposed Order, including in particular:

- (a) the reformulated proposal that the auditor would be 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;
- (b) the ACC/AC negotiating and agreeing audit fees and the scope of audit work, to demonstrate that the ACC/AC is in charge of managing the audit relationship;
- (c) the increased responsibility of the AC for external audit, so as to assist the AC to hold the executive to account and monitor the reporting of performance; and
- (d) the need to incorporate the proposed measures in an Order, rather than introducing them on a comply or explain basis, e.g. via a recommendation to the FRC.

6.2 Composition of Audit Committees

Audit Committees in general often contain (and ACCs often are) Big Four alumni, who in BDO’s experience are more familiar with and have a tendency to favour Big Four firms over Mid-Tier firms. Whilst increased accountability of the auditor to the Audit Committee is welcomed, it is to be hoped that the composition of Audit Committees will broaden and that the “Big Four mindset” will change; whether (and the extent to which) the CC’s remedies will help achieve this remains to be seen.

6.3 Implementation

6.3.1 Paragraph 3.422 states that “*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.*” However, it is not

clear how this is to be implemented, as this does not come within the Order proposed under paragraph 3.421.

6.3.2 See 2.4.2 above regarding timing of implementation.

6.3.3 BDO agrees that the proposed Order should apply to new entrants to the FTSE 350 immediately upon entry to the listing.

7 **REMEDY 6 – EXTENDED REPORTING REQUIREMENTS**

7.1 **Recommendation to FRC**

7.1.1 BDO welcomes the proposed recommendation to the FRC, including the requirement to disclose AQR grades, findings and actions taken by ACs as a result. This complements and supports Remedy 2.

7.1.2 BDO agrees that this remedy should apply to all premium listed companies applying the UK Corporate Governance Code, in the interests of good governance.

7.1.3 BDO welcomes the CC's endorsement of ISA 700.

7.2 **Implementation**

BDO welcomes the CC's recommendation that amendments to the Code be made by 6 April 2014.

8 **REMEDY 7 – COMPETITION OBJECTIVE FOR THE FRC**

8.1 **Recommendation**

8.1.1 BDO welcomes the proposed recommendation, as part of a package of remedies. However, the CC has not to date explicitly stated whether it considers that four audit firms is enough to provide sufficient competition in the audit market for large companies. This is relevant to the proposed competition objective for the FRC: for example, in considering whether the "need for competition" is met at present or at a future point. Several investors and other respondents to the CC have expressed concerns that there is insufficient choice in the relevant market, especially in certain sectors.

8.1.2 Indeed, the outcome of recent tenders demonstrates that concentration is – if anything - getting worse: in particular, in relation to the auditing of banks, where as a result of a recent tender process, PwC will now audit three of the UK's four largest banks.

8.2 **Other comments**

8.2.1 BDO encourages the CC to recommend that the FRC draws its membership from as broad a range of firms as possible, not only or predominantly from the Big Four.

8.2.2 BDO encourages the CC to recommend that the FRC collects relevant data in relation to this market and publishes relevant statistics annually, as part of the performance of its competition objective and in line with the practice of other regulatory bodies, such as Ofcom. These should include in particular details of:

(a) the auditor of each FTSE 350 company;

(b) the amounts payable by each FTSE 350 company to its auditor for:

- (i) audit services; and
- (ii) non-audit services;
- (c) tenders conducted by each FTSE 350 company for its statutory audit, including details of the firms invited to tender and which submitted bids to the company;
- (d) companies which chose to defer going out to tender for their statutory audit and the reasons given for doing so;
- (e) switching of auditors by FTSE 350 companies;
- (f) how FTSE 350 companies have engaged with shareholders in relation to audit issues, including addressing any shareholder concerns identified as a result of such engagement;
- (g) votes held by FTSE 350 companies in relation to their audit reports and the outcomes of those votes, including details of any companies which have decided not to hold an advisory vote in relation to their audit report and the reasons given for not doing so;
- (h) FTSE 350 and other premium listed company audits reviewed by the AQR team in the relevant period and the results of those reviews;
- (i) reports by audit committees on the findings of AQR team reports on their companies; and
- (j) the extent to which FTSE 350 companies certify compliance with the provisions of each of the Orders giving effect to:
 - (i) the CC's Remedy 1 (mandatory tendering);
 - (ii) the CC's Remedy 3 (auditor clauses in loan agreements); and
 - (iii) the CC's Remedy 5 (strengthening accountability of the External Auditor).

8.2.3 The collection and publication of such data would have the following advantages. It would:

- (a) monitor compliance with the CC's remedies package;
- (b) enable objective assessment to be made of the effectiveness of the CC's remedies package, together with any remedies introduced at an EU wide level (see 11 below);
- (c) provide transparency in relation to the implementation of the CC's remedies package both generally and at an individual company level, which would provide an incentive for companies to enhance shareholder engagement, strengthen the accountability of the external auditors, extend reporting and generally give effect to the CC's remedies package; and
- (d) help the FRC to apply and fulfil its competition objective, by:
 - (i) helping to facilitate and establish the extent of competition for the benefit of all stakeholders; and

- (ii) helping the FRC itself to assess competition in the market and determine what actions are necessary or desirable to pursue its competition objective.

9 REMEDIES THE CC IS NOT MINDED TO PURSUE

9.1 Mandatory switching (rotation)

BDO agrees with the CC's proposal not to pursue this remedy, particularly as requirements in this respect may be introduced on an EU wide basis.

9.2 Constraining NAS provision by the auditor

BDO agrees with the CC's proposal in Remedy 5 (see paragraph 3.407) that only the AC shall authorize the external audit firm to carry out any NAS. BDO agrees that this should reduce the levels of NAS purchased from companies' external auditors.

10 EFFECTIVENESS AND PROPORTIONALITY OF THE PROPOSED REMEDIES PACKAGE

10.1 BDO's overall view

BDO considers that the proposed remedies package is necessary, appropriate and proportionate and is confident that it should remedy (or at least go a long way towards remedying) the AECs which the CC has rightly identified.

10.2 Cost Benefit Analysis

10.2.1 BDO agrees with the CC that the proposed remedies package clearly passes a 'cost benefit analysis' (CBA). The CC sets out in paragraph 5.91 of the PDR that a miniscule 0.0018 per cent change in the market capitalization of the FTSE 350 would mean that the benefit of the introduction of the package of remedies would exceed the expected costs.

10.2.2 It is impossible to quantify with precision the improvements to audit and investor confidence that will follow from the proposed remedies. However, the mechanism for benefits is clear. As the European Commission has stated, well-functioning audit "*contributes to investor protection and reduces the cost of capital for companies*".¹ A reduced cost of capital leads to higher valuation (in standard valuation models, such as the NPV approach). The global financial crisis has demonstrated with alarming consequences what can occur when investors begin to doubt the quality of reported financial statements. Robust and improved audit is a key contributor to investor confidence.

10.2.3 The maximum costs of implementation of the package of remedies proposed by the CC (£30m per year) seem to have been estimated in a reasonable way, or may even have been over-estimated. The maximum costs amount to around £86,000 per FTSE 350 company per year.

10.2.4 However, the main expected cost, that of more frequent tendering and switching, is likely to lead to lower prices, which have *not* been figured into the benefits side of the CBA. With audit firms earning over £1 billion per year in fees from FTSE 350 companies, of which £670 million is from audit, it does not require much change in

¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0561:FIN:EN:PDF>

price in order to offset the cost of implementation.² The CC has already found that prices fall with increased switching/tendering³ and, outside the FTSE 350, auditor tenure is already much shorter, reflecting what occurs in a more competitive market.⁴

10.2.5 The CC's finding on price effects is:

*'These figures indicated to us that companies that tendered/switched on average saved an accumulated amount of 34 per cent after three years, or more than 11 per cent a year, related to the direct tender or switch.'*⁵

Thus, according to the CC's analysis, price benefits alone, being roughly £74m per year following a switch (calculated as 11% of £670m total FTSE 350 audit fees), could be more than double the maximum expected cost of remedies (£30m per year).

10.3 **Investor views**

10.3.1 BDO considers that the proposed remedies package is in line with investor views, except that the CC's package does not prohibit certain non-audit services from being provided by the auditor, which has been a concern for investors.

10.3.2 The Oxera investor survey report, which included five of the top ten investment firms as measured by funds under management⁶, found that:

- (a) *"Almost all investors surveyed do not want to see structural separation of the Big Four firms into audit and non-audit activities.*
- (b) *There is broad support for further restrictions on non-audit activities performed by the auditor, with mixed views as to whether this restriction should be a ban on certain services, or a financial restriction with a cap on the ratio of non-audit to audit income. The more popular option would be to prohibit certain non-audit services from being provided by the auditor (such as valuation work).*
- (c) *All interviewees support more re-tendering of audits, which is widely expected to improve the quality of audits by providing a regular opportunity for audit committees to step back and reflect on the quality and independence of the incumbent auditor. Investors surveyed recognise that a re-tendering exercise entails costs for corporates and auditors, and, as such, suggested an interval of five to ten years as the deadline for re-tendering.*
- (d) *A minority think that mandatory re-tendering should be supplemented with the mandatory rotation of audit firms, sometimes as a 'backstop' where companies have not changed their auditor for a very long period (10 to 20*

² http://www.financialdirector.co.uk/digital_assets/6356/Audit.pdf

³ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/130617_review_of_evidence_price_effects_of_switching.pdf

⁴ http://www.financialdirector.co.uk/digital_assets/6356/Audit.pdf

⁵ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/pf_appendices_21_30_glossary.pdf, p. A30-9.

⁶ Oxera interviewed 11 of the UK's major investment firms and pension funds, plus the three main investor associations (the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds).

years). Investors surveyed have sophisticated views on the costs and benefits of introducing mandatory rotation; most have concerns about the temporary impact on quality, and the costs of disruption. However, some also argue that the disruption in itself may be healthy, that audit firms in their pitches claim that they can get up to speed rapidly in new audit assignments, and that changing auditor provides an incentive on the outgoing auditor not to leave itself open to liability or criticism for mistakes that may be picked up by the new auditor.

- (e) *There is little support among investors surveyed for joint or shared audit, although if one of these two options were imposed, shared audit is regarded as the more attractive.*
- (f) *There is almost unanimous support for the removal of 'Big Four only' clauses in financing arrangements. Yet some interviewees suggest that lenders should be free to specify a minimum quality threshold for auditors.*
- (g) *Most investors support minor changes in the process of auditor selection. None wishes to see a radical change in the role of the audit committee as the agent of shareholders in selecting and monitoring an auditor, but most of the larger investors would like more transparency and disclosure, potentially including the opportunity for periodic dialogue between a company's auditor and its shareholders.⁷*

11

ONGOING REVIEW

The Competition and Markets Authority (CMA) should re-examine the statutory audit market for large companies once the CC's remedies, together with any other remedies adopted at an EU level, have been implemented, in order to assess the effectiveness of those remedies. The appropriate point for such a review would probably be five years or so after the adoption of those remedies, with subsequent reviews thereafter. Issues to be considered in such reviews should include:

- What trends can be determined from the information published by the FRC in relation to this market (see 8.2 above) and whether any action should be taken in the light of those trends;
- Market shares of audit firms in relation to the FTSE 350, including the market share held by the Big Four in aggregate;
- Numbers and frequency of audit tenders by FTSE 350 companies, including the extent to which companies choose to explain why they will defer conducting a tender;
- The extent of switching of auditors by FTSE 350 companies;
- The extent of provision of non-audit services to FTSE 350 companies by their statutory auditors;
- Trends in annual reports;
- The extent to which AQR reporting has changed in line with the CC's proposed remedies and the impact of such changes;

⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf

- The frequency and outcomes of advisory votes for shareholders of FTSE 350 companies in relation to the audit report;
- The conduct of the FRC in relation to competition in the audit market;
- The extent to which barriers to expansion and selection faced by Mid-Tier firms in relation to the relevant market have been reduced since publication of the CC's final report on this market investigation; and
- Whether any of the remedies not pursued by the CC should be reconsidered.