



Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
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5 September 2013

Dear Sir

Investigation into the market for statutory audit services

Thank you for advising us of the latest date for any final submission on the Provisional Decision on Remedies (PDR).

In our letter dated 12 August 2013, we drew attention to the importance of ensuring that the proposals being developed by the European Commission (EC) and those proposed in the PDR are complementary, a view shared by the Department of Business, Innovation & Skills (BIS). We therefore thought we should write setting out our views on the implications of developments during August in the negotiation of the provisions relating to the rotation of Public Interest Entity (PIE) audits in the proposed EU Regulation.

Whilst the final format of those provisions has yet to be finalised, and will not be finalised until after the trilogue phase and consideration by the Member States in Council, it is clear that if, as is increasingly likely, the rotation proposal is pursued:

- The Regulation will provide for audit firm rotation after an audit firm has been continuously engaged as the company's auditor for ten years; and
- That period may be extended if either (i) a tender has been undertaken during that ten year period or (ii) the company has had joint auditors throughout that ten year period.

The issue that remains to be resolved is the maximum duration of any extension over and beyond the initial ten year period.

The discussion and analysis in the PDR supporting the proposal that FTSE 350 companies should put their audits out to tender every five years:

- i. Attached importance to the possibility that, because the ten year tender provision was implemented through the Corporate Governance Code and therefore subject to the comply or explain principle, FTSE 350 companies might choose to explain year after year and so defeat the objective of the provision.
- ii. Acknowledged that the period after which a tender should be required [was "a matter of judgement"].

In our view, the EC proposals address these considerations:

- a. The EC rotation proposals remove the concern that the provision in the Corporate Governance Code can be circumvented by use of the 'comply and explain' principle. Every PIE will have to put its audit out to tender within the ten year period.
 - o That will be the case whether the company intends to change its existing audit firm (because good governance would require a tender to be undertaken) or whether it intends to retain its audit firm (because that will be the condition precedent to doing so under the EU Regulation).
 - o The exceptional circumstances provision proposed in the PDR is replicated in the EC proposals
- b. The EC proposals remove any need for a requirement to put an audit out to tender every five years.
 - i. The EC proposals will result in tenders occurring earlier than the tenth year.
 - o Companies are likely to undertake any tender before the tenth year to ensure that they do not have a limited choice because of appointments of audit firms and audit engagement partners made by other companies, or have no choice but to remain with the same audit firm (for example, for industry competition reasons).
 - o This trend has been evident in the UK where a significant number of companies, including some key systemically important companies, have put their audits out to tender in advance of the date when they would have been expected to do so under the Corporate Governance Code.
 - o Once one PIE in a key sector decides to put its audit out to tender, others in the sector follow – to ensure that they have access to appropriately qualified personnel – which accelerates the trend. This is evidenced by the number of tenders taking place in the UK banking sector.
 - ii. Against this background the Commission's proposal that FTSE 350 companies should put their audits out to tender every five years is likely to be ineffective and burdensome.

- A tender at five years (in accordance with the Commission's proposals) would not be an appropriate basis for a company to decide whether to retain its audit firm at ten years under the EC provision. It would not be seen as good governance by investors or regulators.
- Any tender undertaken between the sixth and tenth year would call into question the value of undertaking a tender at five years and increase the risk of tenders being undertaken to comply with the law and with no substantive expectation of change.
- If two tenders were, in practice, required in any ten year period, UK companies would incur cost and management disruption that their European counterparts would not incur.

The FRC keeps the effectiveness of the Corporate Governance Code under continuous review and is willing to commit to review the effectiveness of the provisions relating to the appointment of auditors by PIEs (including FTSE 350 companies) in the light of developing practice following implementation of the Commission's proposals and the coming into force of the EC Regulation. Such a review would enable any changes in practice to be accommodated and, if encompassed in a recommendation, would avoid the inflexibility of an Order in a changing environment.

In our view, there are two further considerations that would support the Commission adopting this approach:

- a) As a result of initiatives by legislators, regulators, and standard setters, a significantly increased focus by companies and investors on the effectiveness of financial reporting and governance over audit issues has been established.

The FRC has introduced a series of improvements to audit, not least to improve reporting of audits both within a company and externally, and will shortly propose a method to implement the Sharman proposals which ask companies to implement more robust risk management and to have these reviewed by the company's auditors.

Other initiatives are being pursued internationally including, for example, the Integrated Reporting initiative, the projects to revise the standard that governs the form and content of the audit report that are being undertaken by the International Audit and Assurance Standards Board and the Public Company Auditing Oversight Board and, of course, the EC proposals.

- b) It is clear from an analysis of the responses to the Commission's PDR that there is substantial concern at the five year period proposed by the Commission. By our analysis of those responses published on the Commission's website up to and including 4 September, 52 respondents have expressly objected to that period; and only 4 have supported it.

More significant than the relative numbers is the fact that those objecting to the five year period are not only audit firms and companies – they include the PRA, the ABI and the IMA (which represent investors generally) and three major institutional investors.

In view of the points that it made in its letter to you, we have shared a copy of this letter with the Department of Business, Innovation & Skills.

We would welcome an opportunity to discuss the points raised in this letter with you.

Yours faithfully



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cc Marie-Anne Mackenzie (BIS)