Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
London
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12 August 2013

Dear Sir

Statutory audit services investigation

We welcome the opportunity to comment on the Provisional Decision on Remedies (Provisional Decision) published by the Competition Commission ('Commission').

Introduction and Summary

We wish to record our concern at the timetable adopted by the Commission for review of its latest proposals.

The FRC's views on the Provisional Decision and the remedies proposed by the Commission can be summarised as follows:

- The FRC welcomes the Commission's decision to reject mandatory rotation, compulsory joint audit and a role for the FRC in the appointment of auditors. It believes that these changes would not have been conducive to audit quality and would have undermined shareholder primacy.

- The FRC supports the objectives that the Commission is seeking to achieve through the remedies it has proposed. The FRC has a number of comments and suggestions, particularly in relation to the work of the AQR and of audit committees, which it believes would enhance the effectiveness of those remedies. These are set out in the following commentary on the individual remedies.

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- The FRC believes that the Commission's proposal that FTSE 350 companies should put their audits out to tender every five years will not achieve the Commission's objective and/or is not proportionate having regard to the cost and risk involved.
- Further, it has concerns that the proposal that AQR findings be disclosed in Audit Committee reports presents a number of practical difficulties and may mislead investors about the quality of the accounts (as opposed to the audit).

The FRC's reasons for its views are set out in the following detailed comments on the Commission's remedies.

Remedy 1 – Mandatory Tendering

The FRC supports the objective of establishing a more dynamic audit market and regards regular tendering as a key means of achieving that objective. The benefits from regular tendering are that:

- It encourages a fresh look at the company's financial reporting and key risk areas, even if the incumbent auditor is retained;
- It guards against complacency on the part of the auditor as well as the familiarity threat to the auditor's independence;
- It stimulates innovation and spreads best practice;
- It allows audit firms which are seeking to expand an opportunity to win new work; and
- It should provide investors an opportunity to reflect on what they want from the audit if, as we advise, the company engages with them on the success criteria for the tender.

It was for those reasons that the FRC introduced the requirement that FTSE 350 companies should put their audits out to tender at least every 10 years.

From the Commission's Provisional Decision, it appears that there are two principal areas of difference between the Commission's proposals and the approach taken by the FRC – the length of the period between tenders and the manner in which the proposed remedy is to be imposed.

(i) *The length of the period between tenders.*

When the FRC consulted on its proposal, there was considerable debate about the period to be specified. That debate recognised the need to balance the benefits summarised above with the risks and costs associated with regular tendering, including that:

- Tendering, especially for large and complex companies, is time-consuming and expensive for the company and prospective auditors.

- A key driver of audit quality is the extent to which an audit firm understands the business of the company to be audited, including the risks it faces. A change of auditor, therefore, carries the risk that audit quality may suffer initially because an incoming audit team does not have that in-depth understanding.

- Much work is required to ensure that incoming auditors are appropriately independent. To achieve independence, existing contracts for non-audit services often need to be unwound (including services which are long-term in nature, some of which involve proprietary products belonging to the accounting firm). In the case of banks and insurance companies, the necessary changes extend to the financial arrangements of the audit firm and its partners and staff.

- Audit firms responding to tenders need to have confidence that those tenders offer opportunities to firms other than the incumbent firm.

- We are concerned that if the retendering period is reduced from ten years, a firm will not be confident of recovering the costs of tendering, introducing innovations and securing any necessary skills. It may therefore be less willing to innovate or, if it has invested, seek a close relationship with the company to increase the chance of reappointment but, in the process, jeopardise its independence.

We therefore continue to believe that our decision to opt for tendering every ten years balanced the benefits with the costs and risks associated with regular tendering.

We are concerned that there is a very real risk that tendering at five yearly intervals will not be taken seriously either by companies or by firms and hence become a sham process which will infect the serious approach already being shown to ten year retendering. We see such a risk arising because:

(i) Audit firms conclude that there is a high probability that the incumbent will be reappointed and so are unwilling to incur the costs and risks involved.

(ii) Audit firms conclude that the commercial advantages of providing non-audit services which are subject to less public scrutiny outweigh the merits of being appointed the auditor to the company concerned.

(iii) Very complex companies, such as the largest financial institutions, conclude that the only practical way to comply with the proposed five year tender requirement is to identify two Big Four firms to act as auditor for alternate five year periods and to use other firms for non-audit service engagements.

(iv) A five year tendering regime may result in firms placing a greater value on the ability of partners and staff to win audit tenders rather than on qualities associated with undertaking a robust and sceptical high quality audit.

In the case of the non-Big Four firms, we are concerned that they may decide not to enter the market because, in addition to the risks set out above, they conclude that:

- the costs of tendering will be high and they have less deep pockets than the large firms;
- five years will be an inadequate period to recover the costs of that tender and/or of securing any necessary skills, hence increasing the firm's cost base;
- any non-audit service engagements may have to be terminated to meet the new EC requirements (see below); and
- the outcome of any tender will be speculative.

As an objective of the Commission's proposed remedy is to increase the opportunity for the non-Big Four firms to access the FTSE 350 audit market, we believe that the Commission should have reliable evidence that non-Big Four firms will in fact bid for a meaningful proportion of FTSE 350 audits.

The European Commission's (EC) proposals to reform the audit market are also relevant to the extent that there is likely to be any interaction between the Commission's proposals and those under discussion in Europe. In our view, there are two areas where such an interaction may arise.

- The discussions between the EC and Member States in relation to mandatory rotation have established that companies that put their audit out to tender should qualify for an extension to any mandatory rotation period. All of those discussions have taken place on the basis that the appropriate period to qualify for such an extension, the tender must occur within 10 years from initial appointment.

- The EC proposals currently provide that a firm may not provide certain non-audit services to a Public Interest Entity (a) during the year preceding that which it will first audit and (b) the year after its audit engagement ceases.

  This proposal will require audit firms to refrain from providing those non-audit services to companies that they hope to be appointed to audit or require companies to complete the audit tender in sufficient time for the firm appointed to terminate any relevant non-audit service engagements more than 12 months before its appointment takes effect.

  If tenders have to occur on a five yearly basis, this provision is likely to increase the probability that firms will evaluate whether their interests are better served by a continuing non-audit services relationship rather than a speculative audit tender – thereby reducing the effectiveness of the tender proposal.

In our view, the risks which we have summarised above to the development of an audit market in which regular tenders become the accepted norm would be substantially ameliorated if the period between tenders remains 10 years.

(ii) *The manner in which the proposed remedy is to be imposed.*

We are disappointed that the Commission intends to introduce this remedy via an Order and to recommend changes to the Corporate Governance Code in line with the Order. The Order would bear on companies and, through the costs of tendering, on investors: in other words on the consumer of the service as much as on the supplier. We believe that the "consumer" should have some choice in the matter and therefore support a comply ot explain approach through the Code.

Comply or explain is at the heart of the UK's approach to corporate governance and the Commission's proposal undermines that long-established and respected approach. Compliance with Code provisions is very high[1] and exceptions generally reflect the fact that compliance may not always be appropriate for every company at all times and explanations are given which investors are able to assess and discuss with the company if they are dissatisfied. This approach promotes shareholder primacy and has operated efficiently, without a need to establish precedent or criteria to assess what circumstances are "exceptional" as would seem to be the case with the suggested Order.

In summary, therefore, we do not believe that the Commission has made the case for this change and we consider that the existing provision requiring tendering after ten years should be given time to demonstrate its effectiveness. In support, we would point to the fact that the existing Corporate Governance Code provision is clearly having the desired effect. There has already been a significant increase in tendering activity (with major companies announcing their intention to put their audits out to tender) and an acknowledgement in audit committee reports that the provision will be complied with in the coming years. And we note that virtually all of the feedback from market participants, including investors, which you have published, supports the FRC's proposals.

[1] In paragraph 3.348 of the Preliminary Decision, the Commission states that Grant Thornton's report shows that in 2012 there was only 25% compliance with the Corporate Governance Code's requirements in respect of disclosure of the activities of the audit committees. However, this is incorrect.

The Grant Thornton report said that *"Encouragingly, the number [of FTSE 350 companies] giving no information reduced considerably, to 15%. However, just one in four companies made informative disclosures around such areas as how the relationship is managed, how performance is evaluated, the length of tenure and the dates of appointment and last tender."*

The items listed in the second sentence did not become Code requirements until October 2012, 18 months after the date when the survey was undertaken. So the actual level of compliance with the version of the Code that applied at the time was 85%, and 25% compliance with requirements that would come into effect 18 months later.

In this context, it is relevant to note that the FRC reviews the operation of the Corporate Governance Code every year and reports publicly on the results of that review. Those reviews will, in the future, cover the level of compliance with the tendering provision. To reinforce the effectiveness of this practice, the FRC would be willing to undertake to reassess the effectiveness of the current Code provision and, in particular, the appropriateness of the 10 year period after the provision had been in effect for 3 years. That would have the additional benefit that the outcome and effect of the EC proposals would be known when that review took place.

Remedy 2 – Audit Quality Review

The FRC supports the Commission's objective of enhancing the effectiveness of audit committee oversight of audits by increasing the availability of information on audit quality at the main firms auditing public interest entities. To achieve this objective the Commission has proposed that (i) Audit Quality Review (AQR) reporting should be extended so that all FTSE 350 companies are inspected on average every five years and (ii) those firms that audit ten or more public interest entities should be inspected and reported upon by the AQR on an annual basis

(i) *All FTSE 350 companies are inspected on average every five years*

We agree in principle that the AQR should aim to inspect least 70 companies in this category each year. However, this is subject to the caveat that some companies in this group, such as investment trusts, are low risk and we should wish to have some flexibility to lengthen the frequency of inspections of these audits if that were necessary to increase scrutiny of high risk audits.

(ii) *Firms auditing ten or more public interest entities should be inspected and reported upon by the AQR on an annual basis*

The second part of this remedy proposes that the nine firms which currently audit more than ten public interest entities, and hence are within full AQR scope, should be inspected and reported on annually.

The table below sets out the number of audits within the AQR scope (public interest entities) audited by each firm as at 31 December 2012:

Firm name	FTSE 350	Other listed, including	Other PIE[2]	Total PIE

[2] The majority of entities in the "Other PIE" category are large private companies

		listed debt		
Deloitte	88	54	225	367
EY	59	67	205	321
KPMG	76	86	293	455
PwC	92	93	391	576
BDO[3]	8	54	43	105
Grant Thornton	5	58	48	111
Baker Tilly	0	10	14	24
CCW	0	0	20	20
Mazars	0	1	10	11

This Table is based on AQR's internal records

In the context of the Commission's objectives, we would be willing to produce public reports annually on BDO and Grant Thornton. Both firms have FTSE 350 clients and audit a large enough number of other public interest entities to allow us to obtain a reasonable sample of audits to inspect annually.

However, we are concerned at the recommendation that AQR should report annually on the smallest three firms in the Table because:

(i) Those firms have no FTSE 350 presence and audit fewer than thirty public interest entities (the majority of which are large private companies, pension funds and charities).

(ii) It would not be sufficient to review firm-wide procedures in isolation – as appears to be suggested by the Commission. Reviews of firm-wide procedures are always accompanied by inspections of individual audits because it is impossible to assess how those procedures operate in practice without considering them in the context of the conduct of actual audits.

(iii) If the objective is to provide information that is relevant to Audit Committees of FTSE 350 companies, we do not believe that that will be achieved by providing information on inspections of charities, pension funds or large private companies.

The AQR now undertakes thematic inspections that focus on particular aspects of the audit process and intends to do so in the future. The results of those thematic inspections, if organised differently, could be used to expand the periodic reports that AQR publishes on the three smallest firms. That would, we believe, produce more relevant information about the quality of the audit work undertaken by those firms – because the aspects of the audit focussed upon are and will be those that contribute to audit quality in all circumstances.

[3] Includes PKF which merged with BDO in March 2013

The Commission suggests that all AQR reports should be published on the same day. We agree that we should aim to do so where practicable, but it is important to note that there are some logistical difficulties associated with this proposal. We believe we should have the flexibility to publish inspection reports when they become available, rather than necessarily having to wait until all are available. This is because we would not want to be in a position where publication of all reports was held up because of delay in finalising the report on, for example, one firm, with the consequence that information on other firms was delayed (particularly as that information would be relevant to those companies running a tender).

The Commission has recognised that there are practical aspects to the elements of this remedy which will impact the FRC. These relate to the additional funding required[4], the timing of publication of individual firm reports and the availability of appropriately qualified resource to undertake the increased number of inspections and provide the governance necessary to ensure the quality and consistency of individual reports. The FRC would wish to consider how to address such matters during its consideration of the Commission's eventual recommendation.

Remedy 3 – Auditor Clauses in Loan Agreements

We support this remedy. We would like to understand the monitoring and enforcement mechanisms the Commission has in mind.

Remedy 4 – Enhanced Shareholder Engagement

We broadly support this proposed remedy but have some additional comments.

(i) *Increased engagement with shareholders*

The FRC has been keen to encourage enhanced shareholder engagement with companies on audit issues and is willing to consider the amendments to the Corporate Governance Code proposed in paragraph 3.342 of the Provisional Decision.

We hope that the changes already made to the Corporate Governance Code to enhance audit committee reporting will provide a starting point for discussions with investors on audit issues and so lead to support for the changes the Commission has proposed (notwithstanding the lack of support that we received when we included similar proposals in our *Effective Company Stewardship* consultation).

(ii) *Advisory vote on the Audit Committee Report*

Shareholders already have three routes by which they can express their views on the adequacy of the Audit Committee Report – through binding annual votes on the report

[4] The incremental costs (of inspection resourcing and the oversight and governance infrastructure) attributable to the Commission's proposals would be between £1.6m and £2.0m.

and accounts; through the individual re-election of each director who is a member of the audit committee; and through the appointment of the auditor. It is therefore unclear to us what an additional advisory vote simply on the sufficiency of the audit committee report would achieve.

Investors have told us that they would be more likely to engage with companies on audit issues if they could have some input into matters such as the desired outcomes from the audit. This would be of particular value prior to a tender taking place. We encourage the Commission to consider adding, as an alternative or additional element of the recommendation, the desirability of discussion between the Audit Committee Chair and major investors on a regular basis and, in any event, before any significant development affecting the company's financial reporting, such as an upcoming tender. Such an extension of the recommendation would, we believe, enhance the effectiveness of this remedy.

(iii) *Encourage institutional investors to engage with companies*

As it would be consistent with our wish to see greater involvement between institutional investors and the companies they invest in, we would be willing to consider the amendments to Principles 3 and 4 suggested in paragraph 3.346 of the Provisional Decision.

It is appropriate to place on record at this stage that, in accordance with our established practice (a practice that has applied equally to proposals emanating from Government), we would consult on any proposed amendments to the Corporate Governance or Stewardship Codes arising from any remedies that the Commission may finally propose.

Remedy 5 – Strengthening the accountability of the External Auditor

We are broadly supportive of the objective that this remedy seeks to achieve - namely a clear separation of the audit committee's role with respect to the oversight and governance of the external auditor from that of the company's executive management and finance function. However, we have a number of issues on the way that the remedy is expressed and how it is proposed to be implemented.

(i) *The importance of maintaining the unitary board*

When we consulted on the original proposals in *Effective Company Stewardship* we received extensive comment to the effect that our proposals would be contrary to the concept of the unitary board (which is enshrined in company law) and that it would be contrary to good corporate governance to impose responsibilities on a committee of a board and then preclude that board from overseeing the discharge of those obligations by the whole board. We would therefore wish to consider with the Commission how its objective might be achieved without compromising the unitary board concept.

(ii) *Maintaining the independence of the auditor*

There are two respects in which the proposed remedy would undermine the independence of the auditor and which are, therefore inappropriate.

It is essential that an auditor, once appointed, has an absolute right to perform all the work it considers necessary to report on the company's financial statements and therefore to determine the scope of the audit it undertakes. We would be very concerned at any suggestion that an audit committee could determine the scope of the audit and therefore the audit work to be undertaken.

Similarly whilst the audit committee may raise concerns about the audit engagement partner, the decision on whether to replace that partner is and must be solely for the audit firm. If the position were to be otherwise, the audit committee would have undue influence over the engagement partner, potentially creating an intimidation threat to that partner's independence.

We would also wish to discuss the method by which the Commission intends to implement this proposed remedy. Such matters are addressed in detail in the existing Corporate Governance Code, the related *Guidance to Audit Committees,* and in Auditing Standards and we believe that amendments to the respective roles of audit committees and auditors should be achieved through amendments to those documents. If the remedy were implemented in this way, it would be possible to ensure that the intention is appropriately and precisely captured, using language that all concerned are used to.

Remedy 6 – Extended Reporting Requirements – in both the Audit Committee's and the auditor's report

The FRC is keen for investors to receive more and better information about the quality of the audit. We also wish to ensure as far as possible that the audit committee reviews the results of inspections and considers how they should be addressed. Publication of the AQR's findings is a means of encouraging audit committees to engage fully with the inspections.

However we need to ensure that the benefits of transparency are not outweighed by:

- Constructive engagement between the AQR and the auditor becoming more legalistic in view of the reputational impact of publication.
- The grades and the AQR's conclusions being misconstrued by investors and others as a comment on the company's financial statements rather than the audit.
- As a result of this misconception, (i) companies seeking to become involved in the AQR process in support of their auditors to try and reduce the likelihood of

an audit receiving a poor grade (ii) and/or the FRC itself becoming embroiled in legal action by companies challenging the grade given to the audit.

Therefore we will consider the recommendation carefully and will consult interested parties but we are not yet able, particularly in the time available, to commit to take this forward as proposed in the Corporate Governance Code.

Remedy 7 – Competition Objective for the FRC

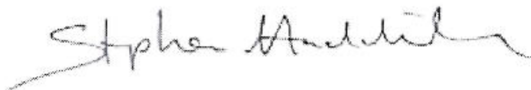
We recognise that the Commission has amended the proposal since it published the additional remedy in June and the FRC Board will consider the proposed amendment to the FRC's articles of association when the Commission's final report has been published.

We would reiterate however that the FRC is not a competition regulator and it does not have the powers which would enable it to function as one. Whilst the FRC has, and will continue to have, due regard for competition issues, its focus must remain the quality of corporate and financial reporting.

We would, of course, be willing to discuss or clarify any the points made in this letter.

I should be grateful if you would acknowledge receipt of this letter.

Yours faithfully



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