

Provisional Decision on Remedies Submission

First, we note that we are strongly supportive of the Commission's decision to abandon the proposal for mandatory rotation of auditors. This seemed a significantly mistaken proposal which ran counter to the Commission's intent to empower audit committees - and from our perspective risked making it harder to call audit committees to account for their actions since it removed some of the key levers of influence from their hands. We regard the proposal for 5-year tendering as a more favourable approach than mandatory rotation (over whatever period), but on balance we are not supportive of a move to a 5-year cycle of tendering, and would strongly favour a 10-year approach.

We say this from our consistent perspective that the market for audit services is not a market that is working currently -- in effect there is no market for competition to bite. We also say this from our perspective that the competition that occurs must be on quality rather than price. We are supportive of an increase in tendering as an opportunity to increase activity within the market, which should add to the competitive dynamic, we hope competition of the right rather than the wrong sort, but we are conscious that for the market to be a genuine one, the tender processes must also be genuine ones.

In a market that is currently not operating we are conscious of the need to make incremental steps and allow the market to begin to operate. We believe that this is already happening with the FRC move to a 10-year cycle for tendering, with a number of companies taking significant steps towards tendering already. We believe that a 5-year tender cycle goes beyond an incremental step and risks failing to awaken the right mindset and approach among audit committees.

We note the Competition Commission's argument that a 5-year tendering horizon would increase the negotiating power of companies. However, we are concerned that companies will instead see a 5-year period as an imposition; our experience of dialogue with audit committee chairs is that they regard a 10-year horizon as somewhat of an imposition but that they are coming to see the benefit of it. They seem unlikely to respond with even this degree of positive attitude should the 5-year period be imposed. Even if a more regular process does give companies greater negotiating power, that would be purely theoretical power if audit committees do not choose to apply it actively. In this regard we would tend to endorse the FRC comments (in its August 12th letter to you) that there is a risk that companies and auditors would not take more frequent tenders seriously and fully commit resources to them. This would risk making some tenders meaningless, and so risk devaluing the tender process overall. In a similar way, we believe that the Competition Commission's other arguments of the benefits of tendering (paragraph 3.149 bullets b, c, d and e) will only be relevant if the tender process is a proper and full one adopted with vigour by the audit committee. In our judgement, from our dialogue with audit committees, this is more likely to occur with tenders occurring on a 10-year rather than 5-year cycle.

We are also firmly of the belief that the benefits the Competition Commission identifies in terms of greater investor confidence in the audit will only be realised where the audit tender is a genuine process. In order to make this a reality, we need a structure and framework which ensures that the tenders that occur are meaningful and the process is not devalued. As noted above, our judgement is that this is more likely to be delivered by a 10-year tender cycle than by a 5-year tender cycle.

In our view there is a further significant downside to choosing a 5-year cycle for tendering. As the Competition Commission notes, this is currently the period in which the audit engagement partner must rotate under UK Ethical Standards, and we would presume that any tendering rules would be explicitly tied to this maximum timeframe for the audit engagement partner's role. However, we note that the 5-year horizon in the UK is shorter than the 7-year global standard, and that the FRC faced significant pressure on this

inconsistency at the last review of the Ethical Standards. We are concerned that a tying of the tendering timetable to a single audit engagement partner rotation could significantly increase the pressure for an extension of the rotation period to 7 years. We believe that this would be an unfortunate step - a 5-year audit engagement partner rotation is preferable in our view, and a maximum tendering period reflecting two such periods, as we have said, seems to us to strike the right balance of inducing a more competitive market while not creating an excessive burden.

I trust these comments are clear, but would be pleased to have further dialogue if that would be useful to you.

With best regards,

Paul Lee
Executive Director - Policy & Best Practice
Hermes Equity Ownership Services Limited