JEB/

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Audit Market Investigation
Competition Commission
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9 August 2013

Dear Sir/Madam

Audit Market Investigation – Provisional Decision on Remedies

ICAS (The Institute of Chartered Accountants of Scotland) welcomes the opportunity to comment on the Competition Commission's (CC) provisional decision of its Statutory Audit Services Investigation, which substantially focusses on the FTSE 350 audit market.

ICAS' Charter requires us to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Our members cover the complete spectrum of senior positions in corporate life; from executive directors in listed companies, including Chief Executives and Finance Directors; non-executive directors including Chairmen and Chairs of Audit Committees; to audit, assurance and specialist partners in accountancy firms and senior positions in public bodies, central and local government and including regulators. We also have many members who work in the fund management industry and therefore comprise some of the investors referred to in the CC report. We have a constant dialogue with our members and it is from their views and practical experiences that we draw our response.

Key Comments

- ICAS welcomes and acknowledges the depth of work that the CC has undertaken in relation to this investigation.
- We trust that the work of the CC will also be influential in relation to the current on-going audit policy debate taking place in the EU. The work of the CC is the only current detailed investigation into the audit market of an individual EU member state of which we are aware.
- ICAS welcomes the fact that the CC has given further consideration to the potential remedies which it initially promoted in its provisional findings report published in February.
- In particular, we welcome the fact that the CC has provisionally decided not to introduce mandatory audit firm rotation.
- We support the CC's decision to instead focus on retendering as a more appropriate remedy. However, we disagree with the CC's proposal to increase the frequency of such tenders. As we stated in our March submission: *"The Financial Reporting Council (FRC), has only recently introduced a provision in the UK Corporate Governance Code that FTSE 350 companies should retender their external audit every ten years on a 'comply or explain' basis. The anecdotal*

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evidence would suggest that this has led to greater consideration being given by boards of directors of the need to consider putting the audit out to tender. Several high profile changes have already taken place in recent weeks and other major corporates have either publicly announced that they are putting their audit out to tender or are giving serious consideration to doing so. In the light of these developments we do not see the need for the CC to recommend the introduction of more frequent retendering or indeed mandatory rotation of the audit firm at the present time."

In the period since our earlier response, this level of activity has continued and culminated in several companies changing their respective auditors. Therefore, we believe that the CC should not seek to alter the retendering period in the short-term but wait to see if the recent change made by the FRC has the desired effect. The change needs time to bed in before a proper assessment of its impact can be made.

- We note the CC's rationale that "*Our provisional view is that five years is an appropriate interval at which to subject the audit relationship to scrutiny and challenge, and that going out to tender at this interval will increase company bargaining power and ensure a competitive service between tender processes. We think that companies should have an opportunity to defer going out to tender by up to two years where there are exceptional reasons to do so."* We question however, whether this does increase the bargaining power of the company. The company can, if it so wishes, put the audit out to tender at any point in time.
- If the CC decides to mandate tendering, then we believe it should stick to the ten year period which has been introduced by the FRC. Reducing the retendering time interval to five years would result in us having a number of concerns. These are summarised as follows:
  - (i) The reduction in retendering period will undoubtedly result in additional costs, both to the company concerned and also the audit firms who decide to tender for the particular audit. Part of these costs will be an increase in the level of disruption faced by businesses as senior management are faced with having to spend more time on what they will view as non-value added matters. In certain sectors this proposal will prove to be particularly disruptive e.g. financial institutions with operations in a number of geographic locations.
  - (ii) In certain sectors the possibility exists that the level of complexity in large companies and groups coupled with the disruptive aspect of regular tenders could have a potential impact on audit quality. It is not clear that this most important criterion has been given sufficient consideration by the CC in this particular context.
- If any change is to be made to the retendering period then we would prefer for this to be implemented via the UK Corporate Governance Code, i.e. on a 'comply or explain' basis rather than on a mandated basis and also without a specified limitation on the period of explanation.

  As we stated in our March response "*The recent Grant Thornton study in relation to the extent of compliance with the UK Corporate Governance Code highlighted the high level of compliance with the UK Corporate Governance Code (Aggregate compliance with individual Code provisions across all FTSE 350 companies was 97 per cent). We therefore do not see the need for such a measure, if introduced, to be enshrined in legislation. It also might unfortunately be perceived by the EU that the 'comply or explain' approach is viewed as weak by an authoritative UK body and therefore might inadvertently lead to other corporate governance measures being mandated in EU law which would remove the level of flexibility that better allows companies to put in place governance measures which best meet their specific requirements. This would be very unfortunate, given the global success story of the Code following its introduction in 1992 (originally as the Cadbury Code)."*

- We are pleased to note that the CC *"found that tenders were thorough, fair, and transparent processes in which the AC had an influential role, ensuring that shareholder interests are given appropriate weight and which strengthen the incentives of audit firms to offer a competitive product."*
- ICAS has a guidance publication entitled "Appraising Your Auditors" which covers the topics of assessment of auditor performance and audit tendering which has been well received in the marketplace since first being published in 2003. It is our intention to revise this guidance and reissue in the near future. We see this guidance as complementary to the recent paper on re-tendering that was issued by the FRC.

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- Whilst we are not opposed to the proposal that the AQR should review and report on the larger Mid-Tier firms on an annual basis as it currently does on the Big 4 firms, we do have concerns as to whether the benefits to be gained will outweigh the additional costs to be incurred.
- Whilst in principle there is merit in the CC's proposal that The Audit Quality Review team (AQR) should review every audit engagement in the FTSE 350 on average every five years, we have concerns regarding the additional costs that will be incurred by the AQR and how these will be funded.
- We support the CC's proposal to prohibit so called 'Big-4-only' clauses in loan documentation.
- We are supportive of the proposed amendments to the Stewardship Code designed to further encourage shareholder engagement.
- Whilst we do not oppose the introduction of an advisory vote on the sufficiency of the disclosures in the Audit Committee (AC) report section of the Annual Report we do question the practical benefits that will be realised by doing so. We would emphasise that the shareholders already have the ability to vote against the re-election of the auditors and indeed the relevant directors if they desire to make a change.
- We believe that whilst there is some merit in the measures that the CC is proposing to be introduced to strengthen the accountability of the external auditor to the AC, we would again urge the CC to recommend that this proposal be taken forward by a change to the UK Corporate Governance Code. One does have to question why the CC feel comfortable in giving the AC more powers re audit fees, scope etc, yet believe that a rule has to be introduced to force ACs into doing something in relation to audit tendering. This approach appears inconsistent and if you trust the AC to manage the audit, then you should be able to trust them to decide the most opportune time for the audit to be tendered under the terms of the UK Corporate Governance Code. Such an approach will allow ACs, and indeed Boards, to make sure they are comfortable with the issue of balance between the auditors, management and themselves. With increased disclosure requirements the shareholders will be able to judge how this is working and of course can ultimately vote against the directors' re-election if they feel this is necessary. We recognise that there may have been instances in the past where that balance has not always been right but that does not justify in our opinion the Order which gives the AC sole responsibility for all aspects of the external audit. Firstly, there needs to be significant input from management in relation to the audit given its reach and complexity and an Order is too inflexible a measure to accommodate that. Secondly, by its very nature an order cuts across the principle of a unitary board, as it empowers some members of the board at the expense of others. It also blurs the executive/non-executive boundary, which is a vitally important distinction and of course significantly increases the workload of the AC. All of this could have unintended consequences.
- On the basis of increased transparency we are broadly supportive that the AC should report to shareholders on the findings of any AQR report concluded on its company during the reporting period, stating the grade awarded and how both the AC and auditor are responding to the findings. We do however have some concerns over how this reporting will be interpreted and great care will be needed in this respect.
- As we believe that it is imperative that the FRC's focus must remain firmly on its primary objective in the area of auditing i.e. to promote audit quality, we therefore have concerns that the FRC should be required to amend its articles of association to include a secondary objective to have due regard to competition.
- We welcome that the CC has provisionally decided not to pursue any of the other following potential remedies:
    - Further constraining NAS provision by the auditor.
    - Joint or major component audit.
    - Shareholder group or FRC responsibility for auditor reappointment.
    - Independently resourced Risk and AC.

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We would be happy to meet to discuss our comments if you would consider this to be helpful to you in concluding your inquiry. If you have any matters you would like to discuss further, please contact David Wood, Executive Director, Technical Policy & Practice Support, or James Barbour, Director, Technical Policy, in the first instance.

Yours faithfully

Anton Colella
Chief Executive

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Specific Comments on Provisional Proposed Remedies

Remedy 1: Mandatory Tendering

We provisionally intend to issue an Order to the effect that:

- ***FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. Companies may defer this obligation for up to two years in exceptional circumstances. The reasons must on each occasion be set out in the Audit Committee Report. Companies must go out to tender by the end of year 7. This compares with the current FRC provisions that require companies to go out to tender every ten years on a 'comply or explain' basis with no limit specified on the number of years that a company could opt to 'explain'.***

- ***Companies have the right to require the incumbent audit firm give them access to specified elements of the audit file for disclosure to rival bidders in a tender process.***

Companies must monitor and certify compliance with the provisions of the Order in the Audit Committee Report.

We also provisionally intend to recommend that the FRC amend the UK Corporate Governance Code in line with the provisions of the proposed Order.

Retendering versus Rotation

We welcome the CC's provisional decision to focus on retendering as a more appropriate remedy to seek to ensure greater competition than mandatory rotation of the audit firm. We agree with the CC's assertion that *"excluding the incumbent from the tender process could have two adverse effects on the competition for an audit engagement. First the company may be prevented from reappointing the auditor it considered best placed to be its auditor; and second, even if not the preferred provider, excluding the incumbent could reduce the strength of the competition for the engagement. The evidence on the availability of alternative auditors is relevant to both effects."*

Period Between Tenders

However, we question the CC's proposal to increase the frequency of such tenders. As we stated in our March submission:

'The Financial Reporting Council (FRC), has only recently introduced a provision in the UK Corporate Governance Code that FTSE 350 companies should retender their external audit every ten years on a 'comply or explain' basis. The anecdotal evidence would suggest that this has led to greater consideration being given by boards of directors of the need to consider putting the audit out to tender. Several high profile changes have already taken place in recent weeks and other major corporates have either publicly announced that they are putting their audit out to tender or are giving serious consideration to doing so. In the light of these developments we do not see the need for the CC to recommend the introduction of more frequent retendering or indeed mandatory rotation of the audit firm at the present time.'

Therefore, we believe that the CC should not seek to alter the retendering period in the short-term but wait to see if the FRC's recent change to the UK Corporate Governance Code has the desired effect. The FRC's change needs time to bed in before a proper assessment of its impact can be made. The evidence to date suggests that it is having an impact and switching is taking place, the most recent example being the decision by HSBC to award its audit to PwC after a number of years of having KPMG as its auditor.

If the CC decides to press ahead with reducing the retendering time interval to five years then we have a number of concerns. These are as follows:

- the reduction in retendering period will undoubtedly result in additional costs, both to the company concerned and also the audit firms who decide to tender for the particular audit

- the possibility exists that the disruptive aspect of regular tenders could have a potential impact on audit quality. It is not clear that this most important criterion has been given sufficient consideration by the CC.
- there is a danger that audit firms will become more restrictive in the tenders in which they participate, if companies are mandated to go out to tender every five years. This could therefore reduce rather than promote competition.
- we believe that it is inevitable that audit fees will rise as the firms will not be in a position to absorb the additional costs related to tendering (both successful and unsuccessful), which they will incur. The significance of this should not be understated. Whether there are any directly related spin-offs in relation to unsuccessful tenders such as the award of the provision of non-audit services remains to be seen.
- we agree with the CC's finding that the main cost to a company of conducting a tender process is the opportunity cost of the time spent by senior management in designing the process and participating in the process. Whilst we note that the CC found that such opportunity costs were deemed to be manageable this does not take account of the fact that the companies within the FTSE 350 are not a homogeneous group. From our perspective, the better quality the tender the more time consuming this process will be in the use of senior management time. Therefore we believe that to require this process to be mandated every 5 years is an unnecessary and onerous burden on business. We would highlight the evidence provided by Barclays in this respect which the CC referred to in its report as follows:

  "tendering processes involved significant disruption to business activities of multinational companies due to their scale, depth and geographical spread. It estimated that the cost of a single tender process in terms of man hours for a group the size of Barclays would involve in excess of 200 staff with a total time spent in excess of 1,000 man days over an estimated project time of two years."

  Therefore, great care has to be taken to ensure that any decision on retendering periods does not impact on the competitiveness of UK business in the global business environment.

Perceived Benefits of Proposal
We note that the CC refers to these as follows at paragraph 3.149:

"(a) It would increase the bargaining power of FTSE 350 companies both during tenders and in between tenders (paragraph 3.13).
(b) It would focus competition on a tender process in which the AC has an influential role in the specification of the process and the auditor selection and contribute to ensuring that shareholder interests are given appropriate weight (paragraph 3.15).
(c) It is likely to stimulate increased choice both within the Big 4 and by Mid-Tier firms for the provision of audit services (paragraphs 3.14 and 3.121 to 3.124)."
(d) It may reduce the perception of a familiarity threat and may lead to improvements in audit quality and innovation through deployment of new personnel and techniques (paragraph 3.16)."

In terms of the perceived benefits of this proposal, in contrast to the existing 10 year period retendering provision, we remain to be convinced by the CC's arguments in 3.149 (a) and (c).

We accept the substance of the argument in 3.149 (b), but believe that the same focus would apply to a ten year retendering requirement. Furthermore, the ten year period approach offers the advantage of being a reduced burden on business in general.

In relation to 3.149(d), whilst this might appear true at face value, other factors have to be considered. Certain companies might feel that five years is too short a period in which to change their auditors and if happy with the incumbent at the end of the five year period may seek to abbreviate the tender process in order to save costs.

Mandatory versus 'Comply or Explain'
If any change is to be made to the duration of the period between tenders then we would prefer for this to be implemented via the UK Corporate Governance Code, i.e. on a 'comply or explain' basis

rather than on a mandated basis (via an order).

As we stated in our March response:

"*The recent Grant Thornton study in relation to the extent of compliance with the UK Corporate Governance Code highlighted the high level of compliance with the UK Corporate Governance Code (Aggregate compliance with individual Code provisions across all FTSE 350 companies was 97 per cent). We therefore do not see the need for such a measure, if introduced, to be enshrined in legislation. It also might unfortunately be perceived by the EU that the 'comply or explain' approach is viewed as weak by an authoritative UK body and therefore might inadvertently lead to other corporate governance measures being mandated in EU law which would remove the level of flexibility that better allows companies to put in place governance measures which best meet their specific requirements. This would be very unfortunate, given the global success story of the Code following its introduction in 1992 (originally as the Cadbury Code)."*

We believe that the CC overestimates the possibility of non-compliance within the FTSE 350 on this matter, if it were to adopt an approach utilising the UK Corporate Governance Code.

Access to Company/Audit Firm Records
Whilst we believe that an "open book" approach would be preferable, we have some sympathy with the CC's comments at paragraph 3.144 and 3.145.

"*We therefore consider that companies should have the power to request that the incumbent firm disclose only specified parts of the file which would provide rival firms with information specific to the audit and which would not compromise the commercial confidentiality of the company or firm or the intellectual property of the incumbent firm. We consider that companies would not have an incentive to undermine the investment incentives of its auditor, current or future, and would be best placed to judge whether disclosure of part of the access file would be beneficial to the tender process. We might expect the disclosure process to operate in much the same way as the data room used by Companies N and W in the case studies (see Appendix 1.1, paragraph 32).*

On-going Costs
Whilst undoubtedly over time there will be scope for firms and companies to reduce the costs of audit tenders as they become more familiar with the process and design them more efficiently, the level of such costs should not be underestimated. Even with more efficient and streamlined processes, substantial costs will still be incurred by both audit firms and by companies.

We note that at paragraph 3.158 of the CC's report:
"We recognize that costs of tendering every five years would be greater for those companies with more complex audit requirements and those subject to stricter independence regulations. For these companies, we might expect both the cost to the company of conducting a tender to be higher and the costs to participating firms to be higher. We would, however, also expect the benefits to be had from tendering every five years to be higher for these companies. In particular:

(a) the resources required to conduct these audits and the fees charged to these companies will also be larger and so therefore the potential gains from promoting more intense competition if this delivers fee reductions and efficiencies in the delivery of audit services to these companies;

(b) the companies with more complex audit requirements are likely to be among those with larger turnover and capitalization. The potential gains to shareholders from improvements in the trust shareholders can place in the audit are therefore likely to be greater for these companies; and

(c) banking audits are often cited as among the most complex. Following the financial crisis the Big 4 auditor firms were criticized for a failure to identify mounting risks.118 For this reason, we consider that the benefits to be had from a remedy that would contribute to restoring trust in audit reports and promoting effective corporate governance would be highly valued in this sector."

We question the logic in the above paragraphs. In particular, we question whether there will be potential gains from promoting more intense completion and potential fee reductions especially given the additional cost burdens imposed by frequent retendering. How does this reconcile with the need for audit quality to be the primary consideration, particularly given the need to take account of the longer-term interests of shareholders.

Tender Process
We are supportive of the CC's provisional decision not to mandate a particular form of tender process.

Ability to Delay Tender Process
Whilst we are supportive of the principle that companies should be able to delay going to tender we would urge the CC to consider recommending that all of its proposals in relation to remedy 1 should be encapsulated within the UK Corporate Governance Code and hence under the 'comply or explain' principle, without a limitation on the time period that an explanation can be given. We believe that market forces will be enough to ensure that companies do not unduly delay going out to tender.

New Entrants to the FTSE 350
We acknowledge that the CC has considered whether special provisions are required for new entrants into the FTSE 350 and concluded this not to be the case. We believe that there is a case for allowing a period of grace of an additional 12 months to any such new entrants.

Transitional Provisions
We do not comment on the proposed transitional provisions on the basis that we would encourage the CC to give the FRC's 10 year retendering provision time to bed in.

Assessment of Remedy 2: Audit Quality Review

We have provisionally decided to recommend to the FRC that:

- **The controls, systems and processes of each of the 'major firms' identified by the FRC (those which have ten or more audit clients in the AQR team's scope) should be reviewed and reported with equal frequency.**

- **The AQR team should review every audit engagement in the FTSE 350 on average every five years, with each individual audit engagement in the FTSE 350 reviewed at least every seven years.**

In principle, there is merit in the CC's conclusion at paragraph 3.183 that:

"…should the frequency of AQR team reporting be increased it would provide greater transparency of audit quality and more timely and reliable identification of emerging trends and issues. Further, if review of audit files were more frequent, companies would receive a more frequent company-specific review of their audit but would also benefit alongside shareholders from more publicly available results regarding the performance of all firms in the market." and paragraph 3.190

"We consider that giving companies more and better information with which to assess the quality of their own auditor and other audit firms will contribute towards companies being able to make a more informed assessment of whether the offering of their incumbent auditor is competitive. "

However, we have concerns as to whether the benefits to be gained will outweigh the additional costs to be incurred and how the additional costs will be funded. If this remedy is introduced then we would encourage consideration being given by the FRC to seeking to streamline the current AQR process. We also believe that the CC somewhat underestimates the audit firms' opportunity costs associated with AQR visits and these would undoubtedly increase if the number of inspections was to increase.

Although we are not opposed to the CC's proposal to require the AQF to report on a larger number of audit firms on an annual basis we have concerns as to whether the benefits to be gained will outweigh the additional costs to be incurred.

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Scope of AQR Reviews
We welcome that the CC has not made any recommendations in relation to the scope and content of the reviews themselves.

Funding of Remedy
We believe that there is merit in the CC's suggestion that:

"A more equitable solution might be for the FRC to levy these costs on the FTSE 350 as an additional fee to preparers of accounts as this cost would be offset directly against the benefits received by shareholders of FTSE 350 companies."

Implementation
If this remedy is to be introduced then we are supportive of the manner in which the CC proposes to implement this remedy i.e. as a recommendation to the FRC to increase the number of FTSE 350 audit files that the AQR reviews each year, set the maximum duration between reviews, and align the frequency of firm-level reviews for all firms auditing FTSE 350 companies. We also welcome that the CC does not state a specific implementation date but takes on board that the FRC would need time to avail itself of the necessary additional resources required.

Assessment of Remedy 3: Auditor clauses in loan agreements

We have provisionally decided on the following remedies in relation to auditor clauses in loan agreements:

- **an Order prohibiting 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:**

— by company, we mean any company whose annual accounts for a financial year must be audited in accordance with Part 16 of the Companies Act 2006;
— by loan agreements we mean any arrangement between such a company and one or more providers of debt capital for the purposes of providing borrowing facilities to that company. This includes bi-lateral and syndicated agreements and public prospectuses in relation to bond issues;
— the prohibition will apply to the relevant provision(s) but does not affect the validity of the rest of the loan agreement;
— the prohibition will not apply to loan agreements currently in force;
— companies must monitor and certify compliance with the Order in their Annual Report; and

- **a recommendation to the Loan Market Association that it amend the auditor clause in its template leveraged loan documentation in line with the provisions of the proposed Order.**

We are supportive of this proposed remedy other than we do not see any need for the introduction of a compliance statement (see below). We agree with the CC that in order to avoid unnecessary complications it should not apply to loan agreements already in existence on the date that the Order comes into force.

Compliance Statement
If such clauses are prohibited we see no value in companies having to include a compliance statement in their annual report. We believe this would merely add further unnecessary clutter to the annual report.

LMA Leveraged Loan Documentation Template
We believe that the CC should recommend to the LMA that it amend its auditor clause accordingly.

Application Date
We are supportive of the Order's proposed application date of 1 October 2014

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Assessment of Remedy 4: Enhanced shareholder engagement

We have provisionally decided to recommend that:

- **The FRC amend the UK Corporate Governance Code by introducing a specific obligation on companies with a Premium Listing:(i) to engage with shareholders through seeking shareholder views on audit issues and stating how any shareholder concerns identified as a result may have been addressed; and (ii) to introduce an advisory vote for shareholders on the sufficiency of disclosure in the Audit Committee Report.**

- **The FRC update the Stewardship Code to encourage institutional investors to engage with investee companies on audit issues, through monitoring investee companies and escalating stewardship activities.**

We are supportive of the general principle of increasing shareholder-auditor engagement where practical.

We are supportive of the CC's proposal that the FRC update the Stewardship Code to encourage institutional investors to engage with investee companies on audit issues, through monitoring investee companies and escalating stewardship activities. Indeed, the ICAS Future of Assurance Working Group in its report of December 2010 recommended that:

"Institutional investors should be willing to engage with their investee companies on the quality of their reporting and the assurance provided on that reporting.

A principle should be added to the UK Stewardship Code:

Institutional investors should be willing to engage with their investee companies on the quality of their reporting and the assurance provided on that reporting.

Guidance on the principle
As part of this engagement institutional investors should:

- *Seek to satisfy themselves that the reporting of the company is sufficient for their needs as investors;*
- *Where that reporting is not sufficient, seek to challenge the Board to improve its reporting;*
- *Seek to engage with the audit committee on the quality of the assurance provided on the annual report including the financial statements and any other assurance provided;*
- *Seek to engage with the audit committee where there is a formal review of the external audit appointment every 5 years;*
- *Seek to engage with the audit committee where there is a re-tendering of the external audit appointment;*
- *Challenge the audit committee and the Board where they have any concerns relating to the independence or objectivity of the external auditor - for example, there could be concern in respect of the re-tendering policy or non-compliance with that policy;;*
- *Notify the company of any concerns on the appointment of the external auditor; and*

As a last resort, be prepared to vote against the appointment of the external auditor if appropriate, explaining the reasoning to the company."

Therefore, we welcome the CC's provisional decision at paragraph 3.346 that the following text in bold be added to the Stewardship Code:

"Principle 3

Institutional investors should monitor their investee companies.
Guidance 144 Effective monitoring is an essential component of stewardship. It should take place regularly and be checked periodically for effectiveness. When monitoring companies, institutional investors should seek to:
• keep abreast of the company's performance;
• keep abreast of developments, both internal and external to the company, that drive the company's value and risks;

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• satisfy themselves that the company's leadership is effective;
• satisfy themselves that the company's board and committees adhere to the spirit of the UK Corporate Governance Code, including through meetings with the chairman and other board members ***including the Audit Committee chair and members;***

• consider the quality of the company's reporting ***including its reporting on the external audit process****; and*

• attend the General Meetings of companies in which they have a major holding, where appropriate and practicable.

…. ***Institutional investors should be willing to engage with their investee companies on the quality of their reporting and the assurance provided on that reporting.***

Principle 4
Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.
Guidance
Institutional investors should set out the circumstances in which they will actively intervene and regularly assess the outcomes of doing so. Intervention should be considered regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional investors may want to intervene include, but are not limited to, when they have concerns about the company's strategy, performance, governance, ***external audit process,*** *remuneration or approach to 145 risks, including those that may arise from social and environmental matters.*
Initial discussions should take place on a confidential basis. However, if companies do not respond constructively when institutional investors intervene, then institutional investors should consider whether to escalate their action, for example, by:
• holding additional meetings with management, ***including Audit Committee chair and members,*** *specifically to discuss concerns;*
• expressing concerns through the company's advisers;
• meeting with the chairman or other board members;
• intervening jointly with other institutions on particular issues;
• making a public statement in advance of General Meetings;
• submitting resolutions and speaking at General Meetings; and
• requisitioning a General Meeting, in some cases proposing to change board membership."

We agree with the CC's assertion that: *"….with more information available to shareholders as a result of recent changes to the UK Corporate Governance Code (see paragraphs 3.430 to 3.432) and ISA 700 (see paragraphs 3.433 to 3.436), shareholders have the opportunity to engage with companies on audit issues at the AGM and/or at other appropriate forums. We would encourage companies and shareholders to ensure that AGMs are effective forums for engagement, for example by making use of technology, and by encouraging meaningful dialogue."*

Advisory Vote for Shareholders
Whilst we do not oppose the introduction of an advisory vote on the sufficiency of the disclosures in the Audit Committee report section of the Annual Report (the Audit Committee Report) we do question the practical benefits that will be realised by doing so. We would emphasise that the shareholders already have the ability to vote against the re-election of the auditors and indeed the relevant directors if they desire to make a change.

Engaging with Shareholders and Seeking Shareholder Views on Audit Issues
We are supportive of the CC's recommended changes to the UK Corporate Governance Code in relation to seeking shareholder views on audit issues.

Implementation of the remedy
We are supportive of the CC's proposed approach i.e. to recommend that the FRC make the appropriate changes to the UK Corporate Governance Code and the Stewardship Code.

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Timetable Implementation
We have concerns that the proposed implementation date of 6 April 2014 may be too early for the changes being proposed and further consideration should be given to delaying their implementation.

Assessment of Remedy 5: Strengthening the accountability of the External Auditor

In order to strengthen the accountability of the external auditor to the AC, we have provisionally decided to make an Order to the effect that:

- **For a FTSE 350 company, only the AC acting collectively or through the ACC is permitted to:**
  - **— negotiate and agree audit fees and the scope of audit work;**
  - **— initiate and supervise a tender process for external audit work and make recommendations for appointment of auditors following a tender process;**
  - **— require replacement of an AEP; and**
  - **— authorize the external audit firm to carry out any NAS.**

- **Further, the auditor should report any audit issue that the AEP considers to be material as soon as is practicable to the AC or ACC, having established the facts of the issue with finance or other relevant company staff.**

- **We intend that companies monitor and certify compliance with the Order in the Audit Committee Report.**

Order vs Recommendation to Amend UK Corporate Governance Code
We believe that whilst there is some merit in the measures that the CC is proposing to be introduced to strengthen the accountability of the external auditor to the AC, we would again urge the CC to recommend that this proposal be taken forward by a change to the UK Corporate Governance Code.

One has to question why the CC feel comfortable in giving the AC more powers re audit fees, scope etc, yet believe that a rule has to be introduced to force ACs into doing something in relation to audit tendering. This approach appears inconsistent and if you trust the AC to manage the audit, then you should be able to trust them to decide the most opportune time for the audit to be tendered under the terms of the UK Corporate Governance Code. Such an approach will allow ACs, and indeed Boards, to make sure they are comfortable with the issue of balance between the auditors, management and themselves. With increased disclosure requirements the shareholders will be able to judge how this is working and of course can ultimately vote against the directors' re-election if they feel this is necessary.

We recognise that there may have been instances in the past where that balance has not always been right but that does not justify in our opinion the Order which gives the AC sole responsibility for all aspects of the external audit. Firstly, there needs to be significant input from management in relation to the audit given its reach and complexity and an Order is too inflexible a measure to accommodate that. Secondly, by its very nature an order cuts across the principle of a unitary board, as it empowers some members of the board at the expense of others. It also blurs the executive/non-executive boundary, which is a vitally important distinction and of course significantly increases the workload of the AC. All of this could have unintended consequences.

Implementation Timetable
We believe that the proposed implementation date i.e. that it should come into effect fully for statutory audit engagements entered into on or after1 October 2014 is reasonable.

New Entrants to FTSE 350
As the CC notes, the FTSE 350 is a 'shifting class' with companies periodically moving in or out of the listing. We disagree however with the CC's thinking that new entrants to the FTSE 350 should be immediately subject to the provisions of the proposed Order. We believe there should be some form of transitional relief, possibly for a period of up to 12 months from the date of entering the FTSE 350.

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Assessment of Remedy 6: Extended reporting requirements—in both the AC's and auditor's report

We provisionally recommend to the FRC that it should amend the UK Corporate Governance Code to include the following additional provision in relation to the Audit Committee Report:

In reporting how the AC has assessed the effectiveness of the auditor, the AC should report on (i) whether the AQR team has concluded a review on the audit of the company's financial statements in the reporting period, (ii) what the principal findings were, including grade, and (iii) how both the AC and auditor are responding to these findings.

- On the basis of increased transparency we are broadly supportive that the AC should report to shareholders on the findings of any AQR report concluded on its company during the reporting period, stating the grade awarded and how both the AC and auditor are responding to the findings. We do however have some concerns over how this reporting will be interpreted and great care will be needed in this respect. We also have no objections to this remedy applying wider than the FTSE 350 i.e. the CC intends that this should be a requirement for all premium listed companies applying the UK Corporate Governance Code.
- We welcome that the CC is not recommending any measures in respect of the audit report on the basis that:
  "the new disclosures required by ISA 700 will be effective in increasing information to companies and shareholders on audit quality, and will thus contribute to increasing company bargaining power and increasing the influence of shareholders in auditor appointment decisions".

Implementation Timetable
We believe that the proposed timetable for this change is rather short i.e. changes should be made to the UK Corporate Governance Code by 6 April 2014 in line with the timing set out in paragraphs 3.367 to 3.370.

Assessment of Remedy 7: Competition objective for the FRC

We have provisionally decided to recommend that:
• The FRC amends its articles of association to give it a competition objective The amendment would require the FRC when exercising its existing functions to do so in a way which has due regard to the need for competition in the statutory audit market for FTSE 350 companies.

As we believe that it is imperative that the FRC's focus must remain firmly on its primary objective in the area of auditing i.e. to promote audit quality, we therefore have concerns that the FRC should be required to amend its articles of association to include a secondary objective to have due regard to competition.