Provisional Decision on Remedies submission

I am writing to object to a number of the Commission's proposals summarised in its report of 22 July.

For the reasons set out at the end of this letter, I am writing in a personal capacity. I am the Chairman of the Audit Committee of Associated British Foods plc a FTSE 100 company operating in some 50 countries, and the Chairman of Savills plc and Templeton Emerging Markets Investment Trust plc, both FTSE 250 companies.

I appreciate that the concentration in the global audit market and the international nature of the service represents a challenge to the Commission but, from the perspective of the purchaser of audit services (and the investors who rely on it), the essentials are that:

- The audit provided is both independent and of the highest quality
- If a change of auditor is required, there is an appropriate alternative provider available.

Audit Quality

The value of the audit lies not in the technical processes (important though they are) but in the insight and experience of the lead audit partner. The search for this capability is at the heart of the selection process, and the realisation of it is central to retention.

A five-yearly retention of the lead audit partner already limits the period for which the benefits are available, but the longer rotation periods of other senior staff and the corporate memory of the audit firm provide some compensation.

It is not in the interest of the quality of audit for there to be a five-yearly retendering requirement for the firm and for the benefits that accrue with experience to be sacrificed at the altar of artificial and unnecessary competition. Such a requirement would also impose a significant additional financial burden on business.

A fundamental responsibility of all directors, through the audit committee, is to ensure that the external audit is both independent and of the highest quality. Over recent years, the FRC has introduced significant changes to the UK Corporate Governance Code which reinforce the independence of audit and the role and responsibility of the audit committee. The quality of audit has been further enhanced through the development of auditing standards and the AQR.

The recent introduction by the FRC of an obligation for the retendering of the external audit after ten years is intended, inter alia, to address the perception that longevity in role can lead to complacency and a deterioration in the quality of audit (I say perception, because I am not aware of direct evidenced correlation between audit failure and length of service).

In my opinion, which I believe is shared by many colleagues in the corporate sector, the Commission's proposal to shorten the period of mandatory retendering to five years puts the audit quality at risk.

In large or complex organisations, including those like ABF operating in scores of difference countries, it takes time for the incoming auditor to understand the culture of the organisation and the risks and issues associated with audit. Similarly, it takes time for an audit committee to build trust in the auditor and for that trust to generate an open relationship In the view of many, even ten years is too short a time limit.

The costs of five-yearly retendering for both companies and audit firms will be substantial (in my opinion materially higher than those cited in the Commission's report) and there is the additional cost of disruption across the organisation. The presumption must be that any increase in the cost of tendering will directly or indirectly be passed on to the consumer of the service.

I can understand that by introducing more frequent tendering the Commission will be able to say that there are more competitions, and the Commission may therefore feel it has done its job. However, this unnecessary churn will put audit quality at risk, increase corporate costs and thereby reduce the competitiveness of UK companies.

Indeed, it seems perverse that in order for a market to be deemed more competitive, the consumer must suffer increased risk and cost. That cannot be right.

Auditor availability

As regards the availability of auditors, there is no evidence of a lack of qualified candidates for all sizes of business and the Commission acknowledges that tender processes appear competitive.

But I am also concerned by the practicalities. As a businessman, I know that bidding for business is an expensive exercise and companies will only tender for work if there are strategic reasons for doing so or if the probability of success and the profitability of the work meets their yardstick. If they consider themselves to be simply a stalking horse, they do not bid. Why should they?

Given the cost and disruption of a tender, it seems very unlikely that, unless there is a problem with the incumbent auditor, a company will wish to make a change after only five years. If this is correct (which I believe it to be) I cannot realistically see why any other firm would want to invest in a tender when the probability of success is low.

It appears to me that the Commission is building a trap for audit firms – "if you don't bid when asked because the probability of success is low, you confirm our view that the market is not competitive". That is both unfair and improper.

I believe that the proposal for five-yearly retendering should be withdrawn and the FRC's ten-yearly cycle, which is already changing the landscape, is allowed to develop and the impact measured and assessed before any further change are made.

AQR

I am concerned about the requirement for every FTSE 350 audit to be reviewed on average every five years. Apart from questions as to whether there would be a sufficient pool of people qualified to undertake such reviews, the more worrying concern is the cost that will almost certainly be charged through to companies either directly through FRC levies or indirectly through audit fees or both. The FRC is well qualified to put in place a review process that provides assurance to both companies and investors on the quality of audit and continues to develop its approach. The Commission proposals in this respect should be withdrawn.

Also of concern are aspects of Remedy 6. As the Commission indicates, the AQR is in part based on judgement – that judgement may be flawed. If an audit committee is to comment publicly on a set of findings, it seems important and in line with natural justice that, if it wishes, the audit committee should be entitled to receive direct input from the AQR team concerned, not least to be able to assess whether in its opinion the AQR judgement is well founded

Role of Management

As indicated above, all directors have an interest in, and a responsibility for, managing risk and the key control processes. The FRC has properly positioned the audit committee to provide leadership and oversight for the audit relationship but to be effective this requires the active involvement of management and not its exclusion.

In shaping Remedy 5 it is important that the proposals are not overly prescriptive and avoid the need for an audit committee to get into a level of detail that is not important in the greater scheme of things and detracts from their primary function of guiding strategy and overseeing governance.

Consultation Period

Finally, I believe that for the Commission to launch a consultative process on 22 July with the holiday season under way for responses by 13 August is tantamount to an abuse of process. It is quite impossible for company boards, audit committees and trade bodies to be assembled at short notice in the first two weeks of August to consider properly these important and complex proposals contained in a document of some 300 pages.

If there is a lack of response to the Commission's invitation to comment on its proposals, it would be unwise to conclude that they meet with approval – it will be because people are scattered across the world on holiday and will not have been able to engage.

If there is any further information you require please contact me at the above email address or at the address below.

Peter Smith
10 August 2013