



Grant Thornton response to the Competition and Market Authority's draft Order on "Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities"

1 Introduction

- 1.1 This memorandum sets out the response by Grant Thornton to the Competition and Market Authority's ("CMA") formal consultation on the draft Order concerning "Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities" ("the Order") which was issued on 24 July 2014 alongside the associated Notice of intention to make an Order.
- 1.2 Appended to this memorandum are marked-up versions of the draft Order (Appendix A) and the explanatory notes to the draft Order (Appendix B) which illustrate our suggested amendments.

2 Auditor provisions in loan agreements

- 2.1 We understand that the CMA does not intend to pursue the draft Order on "Auditor Provisions in Loan Agreements" as the legislation adopted by the EU (in particular Article 16(6) of the Regulation (EU) No 537/2014 regarding specific requirements regarding statutory audit of public-interested entities ("the Regulation")) is more extensive than the CMA's proposed remedy and therefore sufficient to address the concerns which had been identified.
- 2.2 We concur with the CMA's intention in this regard. Whilst this was a key matter for Grant Thornton during the course of the CMA's investigation, the legislation which has been introduced by the EU (in both Directive 2014/56/EU and the Regulation) deals with the key concerns which we highlighted in our previous correspondence with the CMA.

3 Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities

Transitional provisions

- 3.1 We note that the CMA has sought to align the transitional provisions (Part 6) of the Order more closely with those in the Regulation. We note also that the CMA's final report concluded that "We have designed our transitional arrangements to ensure that those companies which have not gone out to tender for the longest time do so as early as possible, but we have retained some elements of the FRC's phased transition to take account of the backlog of companies who have not gone out to tender for more than ten years"¹.

¹ Competition Commission Final Report, section 16.84.

- 3.2 In our view the CMA's revised transitional provisions, whilst being broadly consistent with the transitional provisions provided for in the Regulation, are inconsistent with the premise that companies which have not gone out to tender for the longest period of time should do so as early as possible. That is, under the transitional provisions suggested by the CMA, a company which changed its auditor relatively recently may be required to put its audit mandate out to tender in a shorter timeframe than a company which has not changed its auditor for very many years.
- 3.3 As an example, the transitional provisions as currently drafted provide for a FTSE 350 company which has never changed its auditor to benefit from a 6 year "grace" period before it is first required to put its statutory audit mandate out to tender (in 2020)², whilst a company that last changed its auditor in 2005, say, will have to undertake a tender process in 2016³. This appears to be inconsistent with the recommendations of the CMA's Final Report.
- 3.4 It is our understanding that guidance on the transitional provisions in the Regulation are still being considered in EU implementation workshops and we recommend that the transitional provisions of the draft Order are aligned with the equivalent provisions in the Regulation and any relevant guidance.

Other points

- 3.5 Article 5.2 allows the AC to set a materiality threshold for the level of non-audit services below which authorization by the AC is not required. As previously submitted,⁴ we consider that the AC should be required to disclose this materiality level in the annual report in order that it is transparent and subject to scrutiny by investors. Absent this disclosure, investors will have no ability to review this process. We also remake our suggestion that the Order or explanatory note provide some guidance as to how these thresholds might be determined. The attached amended draft explanatory note suggests making reference to an absolute value or a percentage of the audit fees charged.
- 3.6 As previously submitted⁵, as originally drafted Article 5.1(e) of the draft Order appeared to require AC approval for all non-audit services work, whether conducted by the Company's appointed auditor or an alternative provider of the service. We therefore welcome the CMA's amendments to Article 5.1(e) of the draft Order to make it clear that the need for approval relates only to the Incumbent Auditor. We consider, however, further clarification is needed to paragraph 23 of the Explanatory Notes in this regard and we have marked up that paragraph accordingly.
- 3.7 Whilst the issue of joint audit is not explicitly included in the CMA's consultation, in order for the UK to not "gold plate" the implementation of the Regulation, we believe that UK law should also include the permitted maximum extension to the mandatory auditor rotation period when a company uses joint auditors (the extension being from 10 to 24 years). In our opinion, although joint audit may not at present be widely used in the UK, the UK government should not cut across its voluntary use

² Under Article 6.1(a) of the draft Order.

³ Under Article 6.1(c) of the draft Order.

⁴ See paragraph 2.4.2 of Grant Thornton's submission of response of 20 December 2013 and paragraph 3.7 of Grant Thornton's submission of response of 3 July 2014.

⁵ See paragraph 2.4.3 of Grant Thornton's submission of response of 20 December 2013 and paragraph 3.8 of Grant Thornton's submission of response of 3 July 2014.

by companies nor restrict its use more than other EU Member States. The extension of the mandatory auditor rotation period in the event that a company uses joint auditors would also eliminate the risk that UK rules unnecessarily clash with laws which are allowed in other EU member states and which could cause a potential impairment to existing EU companies with a dual listing in London, or those companies considering such a dual listing.

- 3.8 We have also marked up paragraph 10 and Article 4.1 of the draft Order and explanatory notes 17(d), 18 and 23, for clarity.

DRAFT ORDER – FORMAL CONSULTATION

The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014

Background

1. On 21 October 2011, the Office of Fair Trading, in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the Act), referred the supply of statutory audit services to large companies in the UK to the Competition Commission (CC) for investigation and report.
2. The CC investigated the matters referred to it pursuant to sections 131 and 133 of the Act and, in accordance with section 134(1) of the Act, concluded that there are features of the market or markets which, either alone or in combination, prevent, restrict or distort competition in connection with the supply of statutory audit services to large companies in the UK and, in accordance with section 134(2) of the Act, that there were adverse effects on competition (AECs). The CC published its findings in a report under section 136 of the Act entitled Statutory audit services for large companies market investigation: a report on the provision of statutory audit services to large companies in the UK and notified on 15 October 2013 (the Report).
3. The CC considered, in accordance with section 134(4) of the Act, whether (a) action should be taken by it for the purpose of remedying, mitigating or preventing the AECs or any detrimental effect on customers; and whether (b) it should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the AECs or any detrimental effect on customers; and (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.
4. In the Report, the CC decided on a package of remedies to address the AECs that it found. The remedies included:
 - (a) that companies listed on the FTSE 100 and FTSE 250 indices must put their statutory audit services engagement out to tender not less frequently than every ten years. The CC was of the view that many companies would benefit from going out to tender every five years, but if they choose not to, then the Audit Committee should set out in the Audit Committee Report the financial year in which it next plans to go out to tender and why going out to tender in this year is in the best interests of its members; and
 - (b) measures to strengthen the accountability of the auditor to the Audit Committee, including a stipulation that only the Audit Committee is permitted to negotiate and agree audit fees and the scope of audit work, influence the appointment of an audit engagement partner, initiate and supervise competitive tender processes, make recommendations for appointment of auditors and authorise the auditors to carry out non-audit services.
5. On 1 April 2014 the functions of the CC transferred to the Competition and Markets Authority (CMA) pursuant to Part 3 of the Enterprise and Regulatory Reform Act 2013 and the Enterprise and Regulatory Reform Act 2013 (Commencement No 6, Transitional Provisions and Savings) Order 2014.

6. By virtue of section 138(3) of the Act, the remedies implemented by the CMA must be consistent with the findings in the Report unless there has been a ‘material change of circumstances’ or other ‘special reason’ for deciding differently since preparation of the Report.
7. Since publication of the Report, the European Parliament and the Council have adopted measures reforming the statutory audit market, namely Directive 2014/56/EU and Regulation (EU) No 537/2014. The CMA considers that this constitutes such a material change of circumstance or special reason to justify taking these measures into account in implementing the remedies decided upon in the Report.
8. Directive 2014/56/EU amends Directive 2006/43/EC⁶ on statutory audits of annual and consolidated accounts. Regulation (EU) No 537/2014 (the Regulation) provides specific requirements regarding statutory audit of public interest entities (PIEs), which includes listed companies, credit institutions and insurance undertakings.
9. In particular, PIEs are required to change their statutory auditor every ten years. Member states can, however, by way of derogation, permit shorter rotation periods. By way of further derogation, member states may allow PIEs to extend the audit engagement to up to 20 years, provided that retendering takes place at least every ten years (we understand the UK Government is minded, subject to consultation, to take advantage of this derogation and that this is consistent with the Government’s negotiating position during the negotiation of the EU audit reforms).
10. The transitional provisions in the Regulation provide that where a statutory auditor has been in office for 20 or more consecutive years, the PIE must change its statutory auditor by June 2020. Where a statutory auditor has been in office for ~~between~~ more than 11 and less than 20 consecutive years, the PIE must change its statutory auditor by June 2023.
11. The CMA has given thought as to how its remedies can work effectively with the Regulation so as to provide certainty as to the timing of tenders, whilst giving effect to findings in the Report and incentivising FTSE 350 Companies to tender the audit engagement at periods of less than ten years. The explanatory notes to the Order considers how the Order is expected to operate within the framework of the Regulation.

⁶ Directive 2006/43/EC lays down conditions for the approval and registration of statutory auditors and the rules on independence, objectivity and professional ethics.

The Order

Reference and power

The Competition and Markets Authority (CMA) makes this Order in performance of its duty under section 138 and in exercise of the powers conferred by section 86(1) to (5) and section 87 (each applicable by virtue of section 164), section 161(1), (3) and (4) and paragraphs 2(1), 10, 21(1), 21(2), 21(4) and 22 of Schedule 8 to the Enterprise Act 2002, for the purpose of remedying, mitigating or preventing the adverse effect on competition and any detrimental effects on customers so far as they have resulted, or may be expected to result, from the adverse effect on competition as identified in the report of the Competition Commission entitled Statutory audit services for large companies market investigation: a report on the provision of statutory audit services to large companies in the UK and notified on 15 October 2013, and by virtue of the Enterprise and Regulatory Reform Act 2013 (Commencement No 6, Transitional Provisions and Savings) Order 2014.

Part 1

1. General – title, commencement and scope

- 1.1 This Order may be cited as The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014. This Order shall come into force on 1 January 2015 and applies to Financial Years beginning on or after 1 January 2015.
- 1.2 This Order applies to the provision of Statutory Audit Services in the United Kingdom.
- 1.3 The provisions of this Order apply to a Company from the date on which it enters the FTSE 100 or FTSE 250 index until the date on which it ceases to be a FTSE 350 Company.
- 1.4 The Order shall continue in force until such time as it is varied or revoked under the Act. The variation or revocation of the Order shall not affect the validity or enforceability of any rights or obligations that arose prior to such variation or revocation.

Part 2

2. Interpretation

- 2.1 In this Order:

Act	means the Enterprise Act 2002;
Audit Committee	has the meaning given by paragraph 10B of Schedule 10 to the Companies Act;
Audit Committee Report	means the separate section of a FTSE 350 Company's annual report detailing the work of the Audit Committee in discharging its responsibilities and prepared in accordance with the UK Corporate

	Governance Code as amended from time to time;
Audit Engagement Partner	means the individual identified by an Auditor or Incumbent Auditor as being primarily responsible for the conduct of the Statutory Audit;
Auditor	means a person eligible for appointment as a statutory auditor under Part 42 of the Companies Act;
Auditor Appointment	means the appointment of an Auditor of the accounts of a Company under Part 16 of the Companies Act;
Bidder	means any Auditor participating in a Competitive Tender Process;
CMA	means the Competition and Markets Authority;
Companies Act	means the Companies Act 2006;
Company	means a company formed under the Companies Act;
Competitive Tender Process	means (a) a process by which a Company invites and evaluates bids for the provision of Statutory Audit Services from two or more Auditors; and (b) includes a Competitive Tender Process completed in a period where the Company was not a FTSE 350 Company. Completion of a Competitive Tender Process shall be construed as the first day of the Financial Year in relation to which the Auditor Appointment is made pursuant to that process;
FCA	means the Financial Conduct Authority;
Financial Year	means the financial year of a Company as determined in accordance with section 390 of the Companies Act;
Firm	means an entity, whether or not a legal person, which is not an individual and includes a body corporate, a corporation sole and a partnership or other unincorporated association
FRC	means the Financial Reporting Council;
FTSE 100 index	means the share index maintained by the FTSE Group in connection with the 100 companies listed on the London Stock Exchange with the highest market capitalisation from time to time;
FTSE 250 index	means the share index maintained by the FTSE Group in connection with the 250 companies listed on the London Stock Exchange consisting of the 101 st to 350 th companies with the highest market capitalisation from time to time;
FTSE 350 Company	means a Company whose equity shares are admitted to trading on the London Stock Exchange and which is included on the FTSE 100 index or FTSE 250 index;

FTSE Group	means the business of FTSE International Limited operating under the FTSE Group name;
Group	means a parent undertaking and its subsidiary undertakings;
Incumbent Auditor	means the person serving as Auditor to the FTSE 350 Company at the time at which relevant obligations arise pursuant to this Order;
Listing Rules	means the set of requirements for companies listed on a United Kingdom stock exchange and which are the responsibility of the FCA operating as the United Kingdom Listing Authority;
London Stock Exchange	means the main market of the stock exchange provided by the London Stock Exchange PLC;
Non-Audit Services	means any professional service provided by an Auditor to the FTSE 350 Company other than Statutory Audit Services;
Parent Undertaking	has the meaning given by section 1162 of the Companies Act;
Person	includes any individual, firm, partnership, body corporate or association;
Report	means the report of the CC entitled <i>Statutory audit services for large companies market investigation: a report on the provision of statutory audit services to large companies in the UK</i> and notified on 15 October 2013;
Statutory Audit	means an audit carried out in accordance with Part 16 of the Companies Act;
Statutory Audit Services	means the professional services provided by an Auditor in performing a Statutory Audit;
Statutory Audit Services Agreement	means an agreement between an Auditor and a FTSE 350 Company for the provision of Statutory Audit Services in connection with an Auditor Appointment and includes the renewal of such an agreement in connection with a subsequent Auditor Appointment;
Subsidiary Undertaking	has the meaning given by section 1162 of the Companies Act;
UK Corporate Governance Code	means the FRC's UK Corporate Governance Code which applies to companies with a premium listing of equity shares under the Listing Rules.

2.2 In this Order any reference to:

- (a) 'working day' means any day except for Saturday, Sunday, Christmas Day, Good Friday or a bank holiday under the Banking and Financial Dealings Act 1971; and
- (b) a government department or non-departmental public body or organisation or person includes a reference to its successor in title.

- 2.3 The headings used in the Order are for convenience and have no legal effect.
- 2.4 References to any statute or statutory provisions shall be construed as references to that statute or statutory provision as amended, re-enacted or modified, whether by statute or otherwise.
- 2.5 The Interpretation Act 1978 applies to this Order except where words and expressions are expressly defined.
- 2.6 The provisions of this Order are without prejudice to the duties and liabilities attaching to directors by law.

Part 3

3. The prohibition

- 3.1 An Auditor and a FTSE 350 Company must not enter into or give effect to a Statutory Audit Services Agreement unless:
- (a) subject to Article 6, the FTSE 350 Company has made an Auditor Appointment pursuant to a Competitive Tender Process in relation to one or more of the preceding nine consecutive Financial Years or has conducted a Competitive Tender Process for an Auditor Appointment in relation to the next Financial Year immediately subsequent to the nine preceding Financial Years;
 - (b) the terms of the Statutory Audit Services Agreement, including, to the extent permissible by law and regulations, the Statutory Audit fee and the scope of the Statutory Audit, have been negotiated and agreed only between:
 - (i) the Audit Committee, either acting collectively or through its chairman, for and on behalf of the board of directors; and
 - (ii) the Auditor; and
 - (c) the provisions of Article 4 have been complied with.

Part 4

4. Mandatory use of Competitive Tender Processes – further provisions

- 4.1 Where a FTSE 350 Company has not completed a Competitive Tender Process for Auditor Appointments in relation to five consecutive Financial Years, the Audit Committee must set out in the Audit Committee Report relating to the fifth Financial Year [in which there has been no Competitive Tender Process](#):
- (a) the Financial Year in which the FTSE 350 Company proposes that it will next complete a Competitive Tender Process; and
 - (b) the reasons as to why completing a Competitive Tender Process in the Financial Year proposed is in the best interests of the FTSE 350 Company's members.

- 4.2 The information specified in Article 4.1(a) and (b) must also be supplied by the Audit Committee in each subsequent Audit Committee Report (following the Audit Committee Report referred to in Article 4.1) until such time as the FTSE 350 Company completes a Competitive Tender Process.
- 4.3 Where the Audit Committee considers that the proposed Financial Year is no longer appropriate for the completion of a Competitive Tender Process, it must provide reasons for the decision in the Audit Committee Report published immediately subsequent to the making of the decision.
- 4.4 Subject to Article 6, the FTSE 350 Company, in preparing its tender documents, must have regard to the need to ensure that tender documents allow Bidders to understand its business and the type of Statutory Audit to be carried out.

Part 5

5. Audit Committee responsibilities – further provisions

- 5.1 Only the Audit Committee, acting collectively or through its chairman, and for and on behalf of the board of directors, is permitted:
- (a) to the extent permissible by law and regulations, to negotiate and agree the Statutory Audit fee and the scope of the Statutory Audit;
 - (b) to initiate and supervise a Competitive Tender Process;
 - (c) to make recommendations to the board of directors as to the Auditor Appointment pursuant to the Competitive Tender Process;
 - (d) to influence the appointment of the Audit Engagement Partner; and
 - (e) subject to Article 5.2, and to the extent permitted by law and regulations, to authorise an Incumbent Auditor or an Auditor appointed to replace an Incumbent Auditor to provide any Non-Audit Services to the FTSE 350 Company or the Group of which that FTSE 350 Company is a part, prior to the commencement of those Non-Audit Services.
- 5.2 The Audit Committee may specify a policy for permitted Non-Audit Services including setting materiality thresholds based on the value of the proposed Non-Audit Service engagements, below which the prior authorisation of the Audit Committee is not required. Where a materiality threshold is set, it must be stated in the Audit Committee Report.
- 5.3 The Audit Committee may consult such persons as it deems appropriate in the performance of the obligations in Articles 3.1(b), 4.1, 5.1 and 5.2.

Part 6

6. Transitional provisions – mandatory use of Competitive Tender Processes

- 6.1 Subject to Article 6.2:

- (a) where an Incumbent Auditor has been the subject of Auditor Appointments with a FTSE 350 Company in relation to 20 or more consecutive Financial Years as at 17 June 2014, Articles 3.1(a) and 4.4 shall apply in respect of Auditor Appointments made on or after 17 June 2020; or
 - (b) where an Incumbent Auditor has been the subject of Auditor Appointments with a FTSE 350 Company in relation to 11 or more but less than 20 consecutive Financial Years as at 17 June 2014, Articles 3.1(a) and 4.4 shall apply in respect of Auditor Appointments made on or after 17 June 2023; or
 - (c) where an Incumbent Auditor has been the subject of Auditor Appointments with a FTSE 350 Company in relation to less than 11 consecutive Financial Years as at 17 June 2014, Articles 3.1(a) and 4.4 shall apply in respect of Auditor Appointments made on or after 17 June 2016.
- 6.2 Where an Auditor other than the Incumbent Auditor as at 17 June 2014 is the subject of an Auditor Appointment with a FTSE 350 Company on or after 17 June 2016, Articles 3.1(a) and 4.4 shall apply in respect of that and all subsequent Auditor Appointments.

Part 7

7. Monitoring and compliance

- 7.1 A FTSE 350 Company must include a statement of compliance with the provisions of this Order in the Audit Committee Report for each Financial Year.
- 7.2 The Incumbent Auditor must, where requested by the CMA, provide, within 15 working days of the request, a schedule of the following information to the CMA in relation to each FTSE 350 Company for which it is the Incumbent Auditor on the relevant date:
- (a) the last Financial Year in which the FTSE 350 Company completed a Competitive Tender Process; and
 - (b) in relation to the Audit Committee Report published immediately prior to the relevant date:
 - (i) whether the FTSE 350 Company has included a statement of compliance with the provisions of this Order;
 - (ii) whether the Audit Committee has made a statement in accordance with the provisions in Articles 4.1 or 4.2; and
 - (iii) if the Audit Committee has made such a statement, the next Financial Year in which the FTSE 350 Company intends to complete a Competitive Tender Process.
- 7.3 For the purposes of Article 7.2, ‘**relevant date**’ means [1 January], beginning with [1 January 2016] and annually thereafter.

Part 8

8. Directions by the CMA as to compliance

8.1 The CMA may give directions falling within Article 8.2 to:

- (a) a person specified in the directions; or
- (b) a holder for the time being of an office so specified in any body of persons whether incorporated or unincorporate.

8.2 Directions fall within this paragraph if they are directions:

- (a) to take such actions as may be specified or described in the directions for the purpose of carrying out, or ensuring compliance with, this Order; or
- (b) to do, or refrain from doing anything so specified or described which the person might be required by this Order to do or refrain from doing.

8.3 In Article 8.2 above, ‘actions’ includes steps to introduce and maintain arrangements to ensure that any director, employee or agent of an Auditor, Incumbent Auditor or FTSE 350 Company carries out, or secures compliance with, this Order.

8.4 The CMA may vary or revoke any directions so given.

Part 9

9. Supply of information to the CMA

9.1 Any person to whom this Order applies is required to provide to the CMA any information and documents required for the purposes of enabling the CMA to monitor the carrying out of this Order or any provisions of this Order and/or to review the effectiveness of the operation of this Order, or any provision of this Order.

9.2 Any person to whom this Order applies may be required by the CMA to keep and produce those records specified in writing by the CMA that relate to the operation of any provisions of this Order.

9.3 Any person to whom this Order applies and whom the CMA believes to have information which may be relevant to the monitoring or the review of the operation of any provisions of this Order may be required by the CMA to attend and provide such information in person.

9.4 Subject always to Part 9 of the Act, the CMA may publish any information or documents that it has received in connection with the monitoring or the review of this Order or any provisions of this Order for the purpose of assisting the CMA in the discharge of its functions under or in connection with this Order.

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Draft explanatory notes – Formal Consultation

The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014

This note is not a part of the Order

Introduction

1. The Competition Commission (CC) published its findings in a report under section 136 of the Enterprise Act 2002 (the Act) entitled *Statutory audit services for large companies market investigation: a report on the provision of statutory audit services to large companies in the UK* and notified on 15 October 2013 (the Report).
2. The Report set out the CC's findings that there are features of the market for statutory audit services for large companies which adversely affect competition.
3. The CC decided on a package of remedies to address the adverse effect on competition and the consequential detrimental effects on customers identified in the Report. The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 gives effect to part of these remedies whilst taking into account the provisions of Regulation (EU) No 537/2014 (the Regulation) which governs the audit of public interest entities (PIEs) including FTSE 350 Companies.
4. On 1 April 2014, the functions of the CC transferred to the Competition and Markets Authority (CMA) by virtue of the Enterprise and Regulatory Reform Act 2013 and the Enterprise and Regulatory Reform Act 2013 (Commencement No 6, Transitional Provisions and Savings) Order 2014.
5. This Order applies in relation to Financial Years beginning on or after 1 January 2015. Unless otherwise stated, it is not intended that there should be any further transitional period in relation to any of the provisions contained within the Order.

Possible consequences of not complying with the Order

6. Section 167 of the Act places a duty on any person to whom this Order applies to comply with it. Any person who suffers loss or damage due to a breach of this duty may bring an action.
7. Section 167 of the Act also provides that the CMA can seek to enforce the Order by civil proceedings for an injunction or for any other appropriate relief or remedy.

Review of this Order

8. The CMA has a duty under section 162 of the Act to monitor the operation of the Order. This includes a duty to consider, from time to time, whether the Order should be varied or revoked

in the light of a change of circumstances. Article 9 of the Order requires any person to whom this Order applies to provide the CMA with information to allow it to monitor and review the operation of the Order.

9. It is intended that this Order will continue to apply beyond the application date of the Regulation and that implementation of derogations permitted by the Regulation will require minimal changes to this Order.

Status of this explanatory note

10. Nothing in this explanatory note is legally binding. In the event of a conflict between this explanatory note and any provision of the Order, the Order shall prevail.

Structure of the Order

11. The Order is divided into nine parts:

- Parts 1 and 2 contain general provisions, which include specifying when the Order comes into force, the scope of the Order and definitions that are used throughout the Order (and which are also used in this explanatory note)
- Part 3 prohibits an Auditor and a FTSE 350 Company from entering into or giving effect to a Statutory Audit Services Agreement unless certain conditions are met
- Part 4 contains provisions regarding the use of Competitive Tender Processes
- Part 5 contains provisions regarding Audit Committee responsibilities
- Part 6 contains transitional provisions regarding the mandatory use of Competitive Tender Processes
- Part 7 contains an obligation on FTSE 350 Companies to state compliance with the Order
- Part 8 contains provisions allowing the CMA to give directions as to compliance with the Order
- Part 9 relates to the provision of information to the CMA for the purposes of monitoring compliance with the Order and reviewing its operation

Scope of this explanatory note

12. This explanatory note deals with each of the articles in the Order. Terms used in a particular article are generally defined in that article.

Part 1 – General

13. This provides that the Order applies to the provision of Statutory Audit Services in the UK and that the Order applies in relation to Financial Years beginning on or after 1 January 2015.

14. In view of the fact that the FTSE 100 and FTSE 250 indices incorporate a shifting class, with Companies periodically moving in and out of the listing, Article 1.3 provides that a Company is bound by the Order on entry into either index until such time as it exits both indices.
15. In the Report we indicated that new entrants to the indices should be subject to the Order immediately upon entry. We consider that the provisions of the Order reflect good corporate governance which Companies that aspire to join either index are likely to follow, and in any event, the requirements of the Order can be taken into account and planned for by Companies outside the FTSE 350 listing.

Part 2 – Interpretation

16. Article 2 contains the definitions for the capitalised terms used in the Order.
17. Some key definitions are ‘Auditor’, ‘Auditor Appointment’, ‘Audit Committee’, ‘Competitive Tender Process’, ‘FTSE 350 Company’, ‘Statutory Audit’:
 - (a) **Auditor** – means a person eligible for appointment as statutory auditor under Part 42 of the Companies Act (this includes individuals and Firms). Part 42 of the Companies Act makes provision for the necessary qualifications and proper supervision of auditors, including auditors appointed under Part 16 of the Companies Act.
 - (b) **Auditor Appointment** – means the appointment of an Auditor under Part 16 of the Companies Act.
 - (c) **Audit Committee** – The Companies Act defines Audit Committees by reference to Directive 2006/43/EC. The Audit Committee’s role is to, inter alia, monitor the financial reporting process, monitor the Statutory Audit of the annual and consolidated accounts and review and monitor the independence of the auditor. The UK Corporate Governance Code contains further provisions regarding the role of Audit Committees and provides that an Audit Committee should usually consist of three non-executive directors at least one of which has recent and relevant financial experience.
 - (d) **Competitive Tender Process** – for a valid Competitive Tender Process to take place, the Company must invite at least two Auditors (which may include the Incumbent Auditor) to compete for the provision of Statutory Audit Services. For the purposes of the Order, a Competitive Tender Process includes a tender process held at times when the Company was outside either or both the FTSE indices and a Competitive Tender Process is deemed completed on the first day of the Financial Year in relation to which the Auditor Appointment is made. The Order does not seek to be overly prescriptive as to the use of a particular tender process, however, for the avoidance of doubt, a tender process conducted in accordance with the Regulation would be deemed a Competitive Tender Process for the purposes of this Order.
 - (e) **FTSE 350 Company** – means a company whose equity shares are admitted to trading on the London Stock Exchange and which is included in the FTSE 100 or 250 indices. As noted above, this is a shifting class, with membership changing from time to time

- (f) **Statutory Audit** – means an audit conducted in accordance with the requirements of Part 16 of the Companies Act.
- (g) **Article 2.6** provides that the obligations delegated to the Audit Committee throughout the Order are without prejudice to the responsibilities and liabilities attaching to directors by law. This Order should be interpreted in accordance with the principle of the unitary board with all directors remaining equally responsible for the FTSE 350 Company’s affairs as a matter of law.

Part 3 – The prohibition

18. Article 3 provides that an Auditor and a FTSE 350 Company must not enter into or give effect to a Statutory Audit Services Agreement unless an Auditor Appointment has been made pursuant to a Competitive Tender Process in relation to one or more of the preceding nine consecutive Financial Years [or a Competitive Tender Process for an Auditor Appointment has been made in relation to the next Financial Year immediately subsequent to the nine preceding Financial Years.](#) The aim is to ensure that FTSE 350 Companies put their Statutory Audit Services engagement out to tender every ten years or earlier. This means that an Auditor may not conduct more than ten consecutive Statutory Audits of a FTSE 350 Company without a Competitive Tender Process having taken place. Further, the terms of the Statutory Audit Services Agreement must have been negotiated and agreed between the Audit Committee and the Auditor, and the provisions of Article 4 complied with.

Part 4 – Mandatory use of competitive tender processes – further provisions

19. Articles 4.1 to 4.3 detail the reporting obligations of Audit Committees in relation to the use of Competitive Tender Processes.
20. If a Competitive Tender Process has not been completed for Auditor Appointments in relation to five consecutive Financial Years, the Audit Committee must, in the Audit Committee Report covering the fifth Financial Year, state the Financial Year in which the FTSE 350 Company intends to complete a Competitive Tender Process and why this period is in the best interests of the members. This reporting process must also be repeated in each subsequent Audit Committee Report until the FTSE 350 Company completes a Competitive Tender Process. Where the Audit Committee decides that a proposed Financial Year is no longer the appropriate period in which to conduct a Competitive Tender Process, it must provide reasons for the decision.
21. Article 4.4 provides for information required to be provided to Bidders in a Competitive Tender Process and seeks to align requirements with the Regulation. Tender documents may, for example, include disclosure to Bidders of information on the planning and execution of, and findings of the Incumbent Auditor, in relation to the Statutory Audit of the Group, and a breakdown of the number of hours worked by staff grade, geographic location and principal audit areas.

Part 5 – Audit Committee responsibilities – further provisions

22. Article 5 details matters which are the functions solely of the Audit Committee and includes negotiating and agreeing the Statutory Audit fee, the initiation and supervision of Competitive Tender Processes and making recommendations to the board of directors regarding Auditor Appointment.
23. The Audit Committee is also responsible for authorising the Incumbent Auditor ([i.e. the Incumbent Auditor and/or an Auditor appointed to replace an Incumbent Auditor](#)) to conduct Non-Audit Services prior to the commencement of those services. However, as this may place a disproportionate/unnecessary burden on the Audit Committee, it may set a policy for the pre-approval of Non-Audit Services including setting a threshold for low-value Non-Audit Service engagements. [Where a materiality threshold is set, this threshold must be stated in the Audit Committee Report. This may be set, for example, by reference to an absolute value or a percentage of the audit fees charged.](#)

Part 6 – Transitional provisions – mandatory use of competitive tender processes

24. Article 6 seeks to align transitional provisions regarding mandatory use of Competitive Tender Processes more closely with Article 41 of the Regulation in order to avoid potential conflicts for FTSE 350 Companies, and differs from the transitional provisions envisaged in the Report (which made use of Audit Engagement Partner rotation periods).
25. The Regulation came into force on 17 June 2014 and the application date of the Regulation is 17 June 2016 (Article 44). Article 41 of the Regulation provides as follows:

Transitional provisions

1. As from 17 June 2020, a PIE shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that PIE for 20 and more consecutive years at the date of entry into force of this Regulation.
 2. As from 17 June 2023, a PIE shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that PIE for 11 and more but less than 20 consecutive years at the date of entry into force of this Regulation.
 3. Without prejudice to paragraphs 1 and 2, the audit engagements that were entered into before 16 June 2014 but which are still in place as at 17 June 2016 may remain applicable until the end of the maximum duration referred to in the second subparagraph of Article 17(1) [ie 10 years] or in point (b) of Article 17(2) [ie less than 10 years]. Article 17(4) shall apply.
 4. Article 16(3) shall only apply to audit engagements after the expiry of the period referred to in the second subparagraph of Article 17(1).
26. Articles 6.1(a) and (b) of the Order make use of the dates in Articles 41(1) and (2) of the Regulation by which the Regulation requires that certain PIEs switch Auditor. However, where

an Auditor other than the Incumbent Auditor (as at 17 June 2014) is appointed on or after 17 June 2016, the provisions of Articles 3.1(a) and 4.4 of the Order apply in respect of that appointment and all subsequent Auditor Appointments (Article 6.2 of the Order).

27. Article 6.1(c) provides that where an Incumbent Auditor has held office in relation to less than 11 consecutive Financial Years as at 17 June 2014, the provisions of Articles 3.1(a) and 4.4 apply in respect of Auditor Appointments made on or after 17 June 2016. The timing of a Competitive Tender Process would then depend on when the FTSE 350 Company last put its audit engagement out to tender.
28. While Article 41(3) of the Regulation applies to PIEs that have retained the same Auditor for less than 11 years as at 17 June 2014 and which Auditor is still in place as at 17 June 2016, Article 6.1(c) of the Order covers FTSE 350 Companies that have retained the same Auditor for less than 11 years, irrespective of whether that Auditor is still in place as at 17 June 2016. We consider that this is appropriate because the application dates of the Regulation and the Order differ and so as to avoid a situation where FTSE 350 Companies that have retained an Auditor for less than 11 years as at 17 June 2014 but who shortly after the Order comes into force wish to switch Auditor, from potentially having to go out to tender immediately.
29. This is reinforced by Article 6.2 of the Order. Where a FTSE 350 Company switches Auditor between 17 June 2014 and 16 June 2016, the provisions of Articles 3.1(a) and 4.4 will not apply to that Auditor Appointment. However, where an Auditor other than the Incumbent Auditor (as at 17 June 2014) is appointed on or after 17 June 2016, the provisions of Articles 3.1(a) and 4.4 apply to that and all subsequent appointments.

Part 7 – Monitoring and compliance

30. Article 7.1 provides that FTSE 350 Companies must provide a statement of compliance with the Order in the Audit Committee Report for each Financial Year.
31. Article 7.2 provides that an Incumbent Auditor must provide to the CMA, within 15 working days of a request, certain information in relation to each of the FTSE 350 Companies for which it is serving as Incumbent Auditor. This is so as to assist the CMA in monitoring compliance with and reviewing operation of the Order.

Part 8 – Directions by the CMA as to compliance

32. Article 8 provides that the CMA may give directions as to compliance with the Order.

Part 9 – Supply of information to the CMA

33. Article 9 provides for the supply of information to the CMA, by any person to whom this Order applies, for monitoring compliance with and operation of the Order.

How the use of tender processes provisions in the Order are expected to operate within the Regulation framework

34. The Regulation provides that neither the initial appointment nor any renewal of an audit engagement of a PIE shall exceed a maximum duration of ten years (Article 17(1)).
35. The effect of the Regulation is that PIEs must tender the audit engagement both before the initial appointment (Article 16) and also so as to take effect at the end of the maximum duration. Renewals of statutory auditor appointment within the maximum duration do not require a public tender process.
36. By way of derogation from the maximum duration of ten years, member states may set a maximum duration of less than ten years (Article 17(2)(b)).
37. By way of further derogation, member states may provide that the maximum duration of the audit engagement may be extended to up to 20 years,¹ provided that retendering takes place at least every ten years (Article 17(4)(a)).
38. We understand the UK Government is minded, subject to consultation, to take advantage of this derogation and that this is consistent with the Government's negotiating position during the negotiation of the EU audit reforms.
39. The provisions of the Regulation in combination with this Order will mean, in the base position where the maximum duration of an audit engagement is ten years, that a FTSE 350 Company must go out to tender in respect of the Auditor Appointment that is to take effect at the end of year ten (Regulation, Article 17(1) and this Order, Article 3.1(a)). The maximum duration of the audit engagement may then be extended by a further ten years, to up to 20 years (Regulation, Article 17(4)(a)). At this point, the FTSE 350 Company must switch Auditor, pursuant to a tender (Regulation 17(4)(a)).
40. As mentioned above, it is open to member states to set a lesser maximum duration than ten years. On exercise of this derogation, the maximum duration of an audit engagement may therefore be less than ten years for a FTSE 350 Company (Regulation, Article 17(2)(b) and this Order, Article 3.1(a)). The audit engagement may then be extended along similar lines to those outlined in paragraph 39 above.