15 August 2014

PwC's response to the CMA's formal consultation on the statutory audit services for large companies market inquiry draft order:

Mandatory use of Competitive Tender Processes and Audit Committee Responsibilities (draft) Order 2014

This submission sets out the response by PricewaterhouseCoopers LLP (**PwC**) to the Competition and Markets Authority's (**CMA**'s) formal consultation on the draft Order on the Mandatory use of Competitive Tender Processes and Audit Committee Responsibilities (the **Order**).

The Order contains the position as proposed by the CMA following the adoption by the EU of Regulation (EU) 537/2014 which governs the audit of public interest entities including FTSE 350 companies (the **Regulation**). We agree with the CMA that the adoption of the Regulation should be taken into account in implementing the remedies in the final report dated 15 October 2013 (the **Report**) on the basis that it constitutes a material change of circumstances.[1]

We have three key points to make in response to the Order, which we outline below and develop in more detail in the body of this submission:

(1) The CMA has sought to align its own transitional provisions with those set out in Article 41 of the Regulation. We strongly support this approach as it will create a considerable simplification for those UK companies impacted by both the Regulation and the Order. However, in drafting the transitional provision in paragraph 6.1(c) of the Order, we believe that the CMA may have wrongly interpreted the transitional provision set out in Article 41(3) of the Regulation. This is important as this interpretation, applied to the Regulation, would result in unintended, and adverse, consequences for many public interest entities across the European Union, who fall into the transition category dealt with by Article 41(3). We are concerned that the interpretation implied by the CMA in its draft Order will have an influential effect on other Member State regulatory bodies' interpretation of the Regulation. We suggest, therefore, that the CMA give consideration to the interpretation of Article 41(3) implied in the draft Order.

(2) Our view is that the current wording of Article 3.1(a) setting out the prohibition against re-appointing an auditor for more than ten consecutive years is unclear and would benefit from clarification.

(3) We consider that to apply the regime to companies that join the FTSE 350 with immediate effect could lead to disruptive consequences where an IPO catapults a company into the FTSE 350 within a relatively short period. Our view is that some form of transitional period would be appropriate and would be consistent with the approach under the Regulation.

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[1] Paragraph 7 of the draft Order.

1 Transitional provisions (Part 6)

1.1 We are concerned with the CMA's approach to the transitional provisions in the draft Order. We strongly support the CMA's stated aim of aligning the transitional provisions with Article 41 of the Regulation: although the Regulation deals with mandatory rotation of auditors for European Union public interest entities and the Order deals with mandatory tendering for FTSE 350 companies, in practice it will be of considerable benefit for companies if the two regimes are aligned.

1.2 However, in working towards this objective, we believe that the CMA may have adopted the wrong interpretation of Article 41(3) of the Regulation. This could have an influential effect on other Member State regulatory bodies as they seek to interpret the same Article, and therefore could have an adverse impact on many public interest entities across the European Union. The public interest entities to which this would be most relevant are those in Member States which may choose not to take up the derogation to extend the maximum duration of the audit engagement (as set out in Article 17(4)(a) of the Regulation). Moreover, we believe that the resulting transitional arrangements for tendering set out in the Order may not be appropriate, and do not achieve the objective of the transitional arrangements as stated in the Report. In practice, we believe that this question is relevant to a group of at least 50 FTSE 350 companies who will be affected in the near term by the approach that the CMA takes to this issue. If the CMA's interpretation proves to be influential, many more EU public interest entities would also be affected.

1.3 We explain below:

(a) the CMA's approach to interpreting the Regulation, as reflected in the Order;

(b) why the CMA's interpretation of Article 41(3) of the Regulation may be wrong; and

(c) how the Order should be amended in order to reflect a more logical, coherent and proportionate interpretation.

The CMA's approach to interpreting the Regulation, as reflected in the Order

1.4 Article 41 of the Regulation contains three main parts, each designed to deal with the date by which a Public Interest Entity (**PIE**) is required to change audit firm:

- Article 41(1) sets out the rules for PIEs which have had the same auditor for 20 years or more – they have 6 years from the entry into force of the Regulation to change auditor:

  "As from 17 June 2020, a public-interest entity 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 public-interest entity for 20 and more consecutive years at the date of entry into force of this Regulation."

  Paragraph 6.1(a) of the Order has reflected the requirement in Article 41(1) – for companies where the audit has been in place for 20 years or more to switch auditor from 17 June 2020 – by obliging them to tender at least every ten years in respect of any new auditor appointment made from this time onwards. This means that their first mandatory tender under the Order will coincide with their first mandatory rotation under the

Regulation, and that the UK tendering regime will not impact this cohort of companies on a mandatory basis until 2020.

- Article 41(2) sets out an intermediate regime for PIEs which have changed auditor in the last 20 years but not for 11 years or more. These companies have nine years from the entry into force of the Regulation to change auditor:

  "As from 17 June 2023, a public-interest entity 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 public-interest entity for 11 and more but less than 20 consecutive years at the date of entry into force of this Regulation."

  Paragraph 6.1(b) of the Order has reflected the requirement in Article 41(2) – for companies where the audit has been in place for 11 or more but less than 20 years to switch auditor from 17 June 2023 – by obliging them to tender at least every ten years in respect of any new auditor appointment made from this time onwards. This means that their first mandatory tender under the Order will coincide with their first mandatory rotation under the Regulation, and that the UK tendering regime will not impact this cohort of companies on a mandatory basis until 2023.

- Finally, Article 41(3) deals with the remaining PIEs: i.e. those that have changed auditor in the last 11 years. These companies may retain their auditor for the maximum duration allowed under Article 17 of the Regulation:

  "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) or in point (b) of Article 17(2). Article 17(4) shall apply."

1.5 Article 17 sets out the maximum period allowed under the Regulation before a change of auditor is required. The standard maximum is ten years, but this can be reduced at the discretion of a Member State (under point (b) of Article 17(2)) or alternatively be increased at the discretion of the Member State as follows:

- a possible extension to twenty years, provided a public tender process has been carried out (Article 17(4)(a)); or

- a possible extension to twenty-four years, where a joint audit has been put in place (Article 17(4)(b)).

1.6 The drafting of Article 41(3) leaves open a question that is crucial to applying the provision in practice. When, for those companies which have changed auditor in the last eleven years, does the standard ten year maximum audit appointment period provided for in Article 17 start to run? The drafting does not specify whether this period should be deemed to begin when the Regulation is first applicable (on 17 June 2016) or when the auditor was originally appointed, prior to the application of the Regulation.

1.7 Paragraph 6.1(c) of the Order sets out the CMA's proposed transition arrangements for those companies which have appointed an auditor within the last 11 years, i.e. the same group of companies which are covered by Article 41(3) of the Regulation. For these companies, the Order provides that the provisions on mandatory tendering and provision of information to bidding auditors *"shall apply in respect of Auditor Appointments made on or after 17 June 2016"*.

1.8 This approach appears to be based on an interpretation of the Regulation that takes the relevant start date under Article 41(3) of the Regulation to be the date of the original appointment of the auditor.

Why the CMA's interpretation of Article 41(3) of the Regulation may be incorrect

1.9 The CMA's proposed approach implies an interpretation of Article 41(3) of the Regulation which results in no transitional period before the EU's rotation regime applies to companies which appointed their auditor in the last 11 years, beyond the effective date of the Regulation.

1.10 In contrast to the approach adopted by the CMA, we consider that the correct start date for the purposes of calculating the maximum duration of audit appointment is the date of application of the Regulation - i.e. 17 June 2016. This would mean that a company that had switched auditor in the 11 years prior to the Regulation coming into force would be able to retain its auditor until 2026 (subject to any reduction or extension of this standard ten year period adopted in an individual EU Member State), giving in effect a 12-year transitional period for the company.

1.11 This interpretation fits with the statements of the Commission on how the EU rotation regime should come into force, in particular:

> *"Calibrated transitional periods taking into account the duration of the audit engagement are also foreseen to avoid a cliff effect once the new rules apply."*[2]

As shown by the diagram attached as Annex A, our interpretation leads to clearly calibrated transitional periods – of six, nine and twelve years – for each group of PIEs depending upon the length of their existing audit appointment. Further, these gradually increasing transitional periods comply with the need for a "*smooth transition*" to the new regime highlighted in Recital 32 to the Regulation.

1.12 We set out in more detail below the reasons why we believe that the CMA's approach to interpreting Article 41(3) of the Regulation may be incorrect. We then consider the impact of the UK's stated intention to derogate from the standard ten year maximum period by allowing an extension of a further ten year period provided the company conducts a tender.

Reasons why the CMA's interpretation of Article 41(3) may be incorrect

Article 41(3) would be rendered redundant

1.13 If the relevant start date for the maximum duration of the audit appointment under Article 41(3) is taken to be that of the original appointment of the auditor, then the remaining time before the maximum duration of the audit appointment expires may be very short or non-existent. For

[2] European Commission Statement 14/104, "*European Parliament backs Commission proposals on new rules to improve the quality of statutory audit*", available at http://europa.eu/rapid/press-release_STATEMENT-14-104_en.htm?locale=en.

example, a PIE that appointed its auditor for the first time in 2005 would, immediately that the provisions of the Regulation start to apply (on 17 June 2016), be in breach of its obligations under Article 41(3).[3]

1.14 This means that, for any PIEs which appointed their auditors more than eight years but less than eleven years before the Regulation comes into force, the transitional period would be extremely short, at just the two year period between the coming into force of the Regulation and the provisions starting to apply. This is in reality no transitional period at all, and would effectively render Article 41(3) without force (since the Regulation applies from 17 June 2016 in any event).

Practical and legal problems

1.15 This is precisely the *"cliff effect"* which the Commission stated the transitional arrangements were designed to avoid, and would be far from a "*smooth transition*" for the affected companies[4]. It places a disproportionate burden on those PIEs with auditors in place for less than 11 years in terms of complying with the new legislation. These companies would face a relatively greater burden (in terms of an earlier requirement to rotate their auditor) than PIEs which have had their auditor in place for more than 11 years.

1.16 The practical effect of such an interpretation would be that PIEs with auditors in place for between eight and eleven years would be required to take immediate action to prepare for the imminent effective date of the Regulation. This would be unsatisfactory in terms of legal certainty, which is a key consideration for the transitional provisions (as identified in Recital 32 to the Regulation).

1.17 That this alternative interpretation may not be correct is confirmed when the positions of the different groups of PIEs under the transitional provisions are compared. The interpretation implied by the CMA's Order would mean that the PIEs that had appointed their auditors most recently (i.e. within the last 11 years) would be obliged to rotate their auditor most quickly under the transitional provisions – and potentially before those with audit appointments of longer standing (which would fall within Articles 41(1) or (2)).

1.18 This is demonstrated by the table below, which takes for the purposes of illustration three companies, A, B and C, which appointed auditors 25, 15 and 5 years ago respectively. The final row (in red) shows the outcome based on the interpretation implied by the CMA's Order. This outcome would be illogical since the PIE which appointed its auditor most recently would be required to rotate first – and before the PIE which has had an auditor in place for more than 25 years:

Company	Date of audit appointment	Date of required rotation
Company A	1989	2020
Company B	1999	2023

[3] On the assumption that the maximum permitted duration of the audit appointment remains ten years under Article 17.
[4] As referred to in Recital 32 to the Regulation.

Company	Date of audit appointment	Date of required rotation
Company C	2009	2026*
Company C	2009	2019*

[*Assuming that the standard ten year period applies, rather than a shorter or longer period as permitted by Article 17.]

Inconsistency with aims of the Regulation

1.19 This interpretation also contradicts the specific aim of the Regulation, which is designed to "*address the familiarity threat*"[5] by introducing mandatory rotation of auditors. This threat is not consistently or fairly addressed if companies with a short audit appointment duration are required to rotate before those with a longer audit appointment duration.

1.20 A similar point is illustrated by the table below, which shows the maximum permitted duration of the audit appointment for companies in the three categories identified in Article 41:[6]

Category	Maximum duration of appointment
20 years or more	No maximum
11-20 years	29 years
Less than 11 years	23 years*
Less than 11 years	12 years*

[*As above.]

1.21 As can be seen, this interpretation leads to those companies which appointed their auditors most recently having imposed on them a significantly shorter maximum duration of audit appointment than all other companies. This illogical outcome can be illustrated further with an example: take two companies, Company X which appointed a new auditor in 2002 and Company Y which appointed a new auditor two years later in 2004. Article 41(2) would apply to Company X and Article 41(3) would apply to Company Y. Under the interpretation implied by the CMA's Order, the Regulation would require Company Y to rotate seven years before Company X (in 2016 as compared to 2023 for Company X) – despite having appointed its auditor more recently than Company X.

The impact of the UK Government's stated intention to allow for a ten year extension for an audit appointment provided a tender has taken place

1.22 We understand from paragraph 38 of the Explanatory Note accompanying the Order that the UK Government is minded, subject to consultation, to take advantage of the derogation in Article 17(4)(a) and extend the maximum duration of the audit engagement under the Regulation to 20 years, provided a tender has taken place at the 10 year point. This means

[5] Recital 21 of the Regulation.
[6] For the purposes of presenting this table, we have rounded up to full years for each.

that, under the analyses above (in paragraphs 1.15 – 1.21), those UK companies falling into the category covered by Article 41(3) of the Regulation would be required to tender their audit appointment at the expiry of the maximum duration, but would be permitted to reappoint their incumbent auditor for another ten years, if they wished to do so.

1.23 Notwithstanding this position (which we note remains subject to consultation and confirmation), we still believe that the CMA's implied interpretation of Article 41(3) of the Regulation is inappropriate.

1.24 The implied interpretation is likely to have an influential impact on other EU Member State regulatory bodies seeking to interpret the same clause. These Member States may not take the derogation in Article 17(4)(a).

1.25 Moreover, as drafted, the provisions of the Order mean that FTSE 350 companies which have appointed their auditors most recently will have to re-tender their audit most quickly. This leads to a similar set of illogical results as outlined above in respect of the CMA's approach to the interpretation of the Regulation. In particular, a FTSE 350 company which tendered and appointed a new auditor in 2004 would have to conduct another tender in 2016, some seven years **before** a FTSE 350 company which tendered and appointed a new auditor in 2002 (and which would have to re-tender in 2023).

1.26 This approach runs counter to the provisions in the Report which expressly provided that in designing the original draft transitional provisions, the CMA sought – sensibly and appropriately – to ensure that:

(a) "*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*";[7] and

(b) "*companies and firms have adequate notice in advance of the requirement to go out to tender in order that they have the opportunity to plan an effective tender process*."[8]

1.27 The new proposed transitional arrangements will have the opposite effect: FTSE 350 companies which have not gone out to tender for the longest time will have a longer – not a shorter – period to tender relative to those FTSE 350 companies which have tendered (and appointed a new auditor) most recently. FTSE 350 companies where the audit firm has been in place for less than 11 years will in some cases have very little notice in advance of the requirement to tender.

How the Order could be amended to reflect a logical, coherent and proportionate approach

1.28 We request that the CMA reconsiders its approach on this point before the Order is adopted. In particular, in order to achieve consistency with the correct interpretation of Article 41(3) of the Regulation, Article 6.1(c) of the Order could be amended so that Article 3.1(a) applies in respect of Auditor Appointments made on or after **17 June 2026**.

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[7] Paragraph 16.84 of the Report.
[8] Paragraph 16.85 of the Report.

2 The prohibition (Part 3): Maximum duration of audit appointment

2.1 We believe that the drafting of Article 3.1(a) is unclear. Our concern is with the second part of the provision, underlined below:

> *"An Auditor and a FTSE 350 Company must not enter into or give effect to a Statutory Audit Services Agreement unless 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 <u>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</u>".*

2.2 The first part of the provision states that having conducted a tender in year one, a FTSE 350 Company can continue to appoint the same auditor without conducting a further tender in years two to ten, since until and including that point the FTSE 350 Company will have appointed its auditor via a tender in one of the preceding nine years.

2.3 However, the underlined part of the provision then says that the auditor can be appointed in year ten (i.e. immediately subsequent to the nine preceding financial years) if the Company has conducted a tender process in that year. This is superfluous and confusing since the first part of the provision states that it is acceptable to appoint the same auditor in year ten without completing a tender.

2.4 Take the example of a company which tendered in 2009 and appointed an auditor as a result of the tender. The first year of the audit appointment would be the year ending 31 December 2010. If the company wished to appoint the same auditor for the year ending 31 December 2019 without conducting a tender it would be able to do so, since that would be year ten of the audit appointment. However, and contradicting this position, the underlined part of the provision seems to suggest that a tender <u>is required</u> in year ten.

2.5 Either the second part of the provision should be removed, or it should be amended to refer to the *"the next Financial Year immediately subsequent to the **ten** preceding Financial Years"*.

3 The prohibition (Part 3): Immediate application

3.1 We note that the definition of a FTSE 350 Company and the obligations contained in Part 3 means that for a company that undertakes an IPO and consequently is immediately included in the FTSE 350 the Order will apply in full immediately and retrospectively. In other words, such a company, if it has not conducted a tender in the previous ten years, would immediately on joining the FTSE 350 be in breach of its obligations under the Order.

3.2 A similar issue applies to companies that list and enter the FTSE 350 between 17 June 2014 and 17 June 2016. For these companies there is no transitional arrangement, so they will be subject to the tendering regime as soon as the Order comes into force (from 1 January 2015) – and may immediately be in breach of their obligations under the Order as of this date if they have not conducted a tender in the previous ten years.

3.3 While the provisions of the Order may reflect good corporate governance (as set out in paragraph 15 of the Explanatory Note), the effect of not allowing any provision for companies to make the transition to the regime may be particularly harsh in the circumstances where an IPO

catapults a company into the FTSE 350 within a relatively short period. Our view is that some form of transitional period is necessary for companies in such a situation. Given the time required to prepare and conduct a thorough tender process, it may be difficult for such a company to anticipate its potential admission to the FTSE 350 sufficiently far in advance to have prepared and conducted an audit tender process in good time – especially given the management team will also be dealing with the considerable demands of preparing for an IPO.[9]

3.4 This potential difficulty is recognised and provided for in the EU regime, where Article 17(8) of the Regulation states as follows:

> *"For the purposes of this Article, the duration of the audit engagement shall be calculated as from the first financial year covered in the audit engagement letter in which the statutory auditor or the audit firm has been appointed for the first time for the carrying-out of consecutive statutory audits for the same **public-interest entity**."*

3.5 In other words, time only runs for the purposes of applying the Regulation from the point at which the auditor is appointed to audit the public-interest entity. Prior to an IPO the company would not have been a public-interest entity[10], and that period would not be counted for the purpose of applying the Regulation. This approach would assist both companies that list and become part of the FTSE 350 for the first time after the Order comes into force, and companies which list and become part of the FTSE 350 between 17 June 2014 and 17 June 2016.

3.6 We believe there are strong arguments for adopting an approach that is consistent in this respect with that already adopted by the EU in the Regulation, and indeed to fail to do so exacerbates the difficulties outlined above for newly listed companies within the FTSE 350 as it will require them to manage two regimes with effectively different transitional arrangements. Under the Order a newly listed FTSE 350 company may be required to tender immediately, whereas under the Regulation a new public-interest entity would not be required to rotate its auditor for ten years (subject to the Member State's approach to the maximum period of appointment). The position is not as difficult for companies which are already listed but are outside the FTSE 350, as they will already be subject to the EU regime.

PricewaterhouseCoopers LLP

15 August 2014

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[9] Further, given that pre-IPO a private company may not have had an audit committee, any pre-IPO audit appointment may not have complied with the requirements of Article 3.1(b) of the Order.

[10] Unless it qualifies as such under the provisions relating to credit institutions or insurance undertakings.

15 August 2014

Annex A