Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
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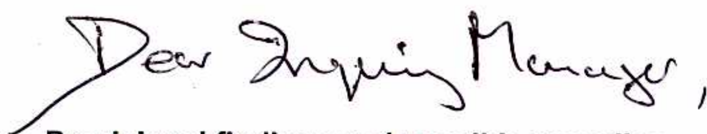

Provisional findings and possible remedies

The FRC has for some time been keen that the longstanding question of concentration in the audit market should be properly considered in detail by the competition authorities and we welcome the fact that this has now been done so comprehensively.

We believe that it is of the utmost importance that auditors serve the needs of investors effectively, and we welcome the consideration of proposals aimed at reducing any risk of this not happening. We also welcome the way in which many of the possible remedies support the significant changes recently introduced by the FRC, particularly in respect of tendering and the enhanced reporting by auditors and audit committees. We look forward to the opportunity to work with the Commission to understand the costs and benefits associated with proposed remedies that go beyond those recently introduced by the FRC, which themselves reflected our analysis of our consultation.

As the Commision knows we have been concerned with raising the level of audit quality and believe that significant progress has been made, although there is more to do as the preliminary report suggests. We feel that one particular area for improvement is the extent to which the firms innovate whether in the context of their audit work or in their reports. We believe it is particularly important to consider whether the proposed remedies will have a positive effect in this respect.

One of our biggest concerns about market concentration is the likely impact of a Big Four firm leaving the market. Such an event would have a major short term effect on capital markets and may in the longer term, damage confidence in corporate and financial reporting - as well as further exacerbating the adverse effect on competition which the Competition Commission rightly identifies. We are working with the large firms and with other regulators on the development of contingency plans to manage a situation where the survival of one of the Big Four firms was at risk. It would be helpful if – indeed, we think it important that - the Commission emphasises (i) the undesirability of the market becoming yet more concentrated and (ii) the importance of those with regulatory responsibility for the market, including competition authorities, exercising their powers to prevent such further concentration. In that context, it would be helpful if the Commission were to emphasise the hurdles that would

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need to be overcome if the market were to concentrate further, and the likely need for action designed to reduce the resultant concentration.

In relation to the remedies proposed in the Commission's report we have a number of observations which are summarised below.

1 Mandatory tendering

The report acknowledges the recent changes to the FRC's UK Corporate Governance Code, including the new provision for FTSE 350 companies to put their audits out to tender every ten years on a "comply or explain" basis. Since we introduced this measure we have explored how it is being applied with audit committee chairs, investors and auditors. It appears to be working well and generating pressure to consider switching. We believe, therefore, that this provision should be given time to take effect before further changes are made. We should like to understand whether evidence of a need for a further change emerged in the course of the Commission's consultation and discuss how progress can best be measured. It should be noted that there is no guarantee that mandatory tendering or rotation will reduce concentration in the audit market. Indeed concentration may increase as non-Big Four firms find their existing audits put out to tender. For that reason, our primary reason for introducing the new provision was to enhance independence and quality.

The Commission's remedies involving tendering and firm rotation (see below) are both expressed as mandatory – which would be of considerable concern to us. "Comply or explain" is an important facet of the UK's governance regime. Our most recent survey illustrated a 90% compliance rate with the requirements of the Code. "Comply or explain" has allowed the UK's governance regime to develop further and more quickly than would otherwise be the case and appropriately recognises the role of the investor in its enforcement.

We would also be concerned that a mandatory regime, removing the flexibility of "comply or explain", could lead to retendering in an inappropriate year, contrary to investors' interests, for example when the challenges facing a business, such as a major restructuring or take-over defence, make audit continuity important. Such an outcome is inconsistent with the Commission's objective of ensuring auditors better serve the needs of shareholders.

Concerns that comply and explain provides an ineffective stimulus are, we believe, misplaced and the Code requirement that directors be re-elected annually reinforces the need for a company, and its directors, to take decisions in the interests of shareholders. Recent announcements from Barclays and HSBC of their intentions to tender their contracts for audit services directly as a result of the FRC's recommendations reinforce this view.

2 Mandatory firm rotation

We have consistently opposed mandatory firm rotation because we consider it reduces choice and may have an adverse effect on audit quality.

Choice - Companies need to be able to secure the best auditor for their business and should not have their choice of auditor artificially constrained. This is particularly necessary when not all audit firms have expertise in a company's business area – such as insurance and banking.

Quality - Were a company not able to secure an auditor with expertise in a particular business area, there would be an undesirable risk to audit quality.

There is also a risk that this remedy would effectively undermine the authority of the audit committee operating in the best interests of investors by taking the question of reappointment out of their hands. That would be inconsistent with the Commission's views on the role and accountability of the committee.

The prospect of rotation also does not guarantee that new firms will emerge. In some sectors where only 2 or 3 audit firms currently compete for work, rotation could therefore lead to a danger of a company having no effective choice. We make this point having heard from mid-tier firms that they are not contemplating investing to enter the market for major and complex clients in the very top end of the FTSE.

There is a suggestion that the FRC should grant waivers from a rotation requirement to companies who have difficulty obtaining an alternative auditor. We are reluctant to take on such a role because we believe it would fracture the line of accountability from the board to shareholders with whom the ultimate decision whether to accept the 'explanation' should rest.

3 Expanded remit and/or frequency of Audit Quality Reporting (AQR)

The UK's AQR reporting regime is the most transparent in the world. The frequency of inspections and selection of audits for review is influenced both by our legislative obligations and our determination of the risks associated with different entities comprising the FTSE350. For example we are more likely to inspect the audit of a major bank than an investment trust. Notwithstanding this, there is always room for further improvement and we agree that there is scope to consider more frequent AQR inspections in some cases of higher risk and more detailed reporting. This is one area where targeting can be achieved and have an impact on poor performance. As the report acknowledges any such changes will be subject to the resources and funding being available. We look forward to discussing with the Commission how this proposal might be achieved in practice.

One suggestion in the report is that the FRC should revisit key audit judgements based on information which is available at the time of the review, but not at the time of the original audit. We would like to explore what this might mean in practice; we would need to be careful that the quality of the audit is not assessed on the basis of information which the auditor could not realistically have known at the time that the judgements were made. It is also important that we do not create a moral hazard problem, as in subsequent years the company and its auditors may tend just to follow the previous views of inspectors even though circumstances may have changed.

4 Prohibition of "Big Four only" clauses in loan documentation

We support a ban on "Big Four only" clauses in loan and other banking agreements.

5 Strengthen accountability of the external auditor to the audit committee

We support the principle underlying this remedy and note that recent changes to the Corporate Governance Code have increased the responsibility of the audit committee in respect of reporting to shareholders on its oversight of the external auditor. We have also provided for annual re-election of directors which enhances investors' opportunity to hold the audit committee chair to account if the report is unsatisfactory.

To assist the audit committee in their reporting to investors and to reduce the risk that issues are resolved between the finance director and auditor without reference to the audit committee, we have recently introduced extended reporting requirements for both auditors and audit committees:

> We have increased the nature and extent of the matters that auditors are required to report to audit committees.
>
> We have extended the matters that audit committees are required to address in their reports to investors.

In particular, we have made it clear that both should address the issues that arose in the course of the audit and how those issues have been resolved.

To underpin these developments, we also introduced additional reporting obligations on the auditor to investors where in the auditor's opinion the report of the audit committee does not cover all of the key aspects of the audit.

We are concerned that the proposals envisage a much enlarged role for the audit committee in the resolution of issues. We are concerned with the practicalities of excluding the finance director from these discussions at an early stage. It is unlikely that an auditor will be able to determine whether a matter is an issue or not without detailed discussions with the finance director. Further we should like to explore whether the non-executives would be able to discharge this responsibility and whether the proposals as written threaten the principle of collective board responsibility. We would also wish to ensure that auditors do not lose sight of their responsibility to report to shareholders in the event that they remain concerned that matters have not been adequately resolved as a result of their reporting to and action by the audit committee.

As in the case of mandatory tendering, we should like to discuss the evidence the Commission has gathered in this area, whether it would make sense to allow the recent changes to take effect and what evidence of their impact we should gather.

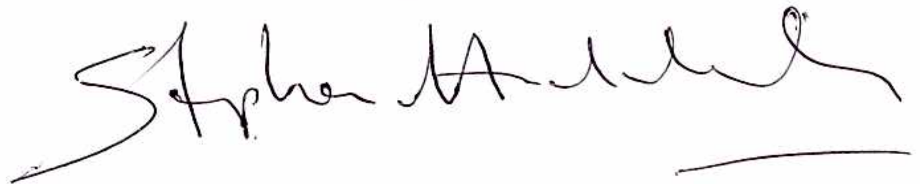
6 Enhanced shareholder-auditor engagement

Auditors are ultimately accountable to shareholders and in principle we welcome proposals for enhanced engagement between the two. We would note, however, that similar proposals included in our 2011 *Effective Company Stewardship* consultation received a largely negative response from investors and other market participants. Clearly for major changes to be effective, investors need to be willing and able to devote sufficient time and effort to proper engagement with the auditors. Most investors who responded to our consultation indicated that they would not be able to do so.

In view of this we would suggest that changes in this area should not rely upon significant time commitment from investors. The Commission's proposals on the auditor and/or the audit committee chair taking direct questions from investors at the AGM would seem to strike the right balance and we look forward to working with the Commission on how this might be achieved in practice.

7 Extended reporting requirements

The Commission recognises the existing UK and international work streams on the corporate and auditor reporting model and notes that the FRC is best placed to progress work in this area. We will be pleased to work with the Commission on the development of these proposals over the coming months.



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