

Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
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Statutory Audit Services Market Investigation – remedies addressed to FRC

I am writing on behalf of the Financial Reporting Council (FRC) regarding those remedies which are addressed to us.

In considering our response to the remedies we have followed four key principles:

- (1) we should pursue remedies related to governance in accordance with our established processes and practices ie following careful consultation.
- (2) we should not breach our principle that the Corporate Governance Code operates on a “comply or explain” basis.
- (3) in relation to audit inspection we should not compromise on quality by seeking to shrink our existing scope or reduce the work done on each inspection in order to increase our coverage of the FTSE 350.
- (4) in supporting competition in the audit market we should not compromise our primary goal which is audit quality.

Our comments on the individual remedies are as follows.

Remedy 1 – Mandatory ten year audit tendering for FTSE 350 companies

The first remedy provides for mandatory audit tendering by FTSE 350 companies at least every ten years. The remedy, which has been scaled back from the original proposal for five year mandatory tendering, also includes provisions for companies:

- where they have not tendered for five or more years to explain in their Audit Committee reports when they propose to tender and why it will be best for shareholders; and
- monitor and certify their compliance with the Order in the Audit Committee reports.

This remedy is to be introduced by Order but the Commission has also recommended that the FRC aligns the Corporate Governance Code with the Order.

The comply or explain philosophy is the basis of the Corporate Governance Code. Amending the Code to include a mandatory provision is not in keeping with this philosophy. Accordingly, we believe that the most appropriate way to address this is to remove the reference to tendering from the Code. We are issuing a consultation on a number of potential changes to the Code in the first half of 2014 and we intend to include this point within that consultation. We expect to cover other aspects of the Order relating to Audit Committee reporting in an appendix to the FRC's Guidance to Audit Committees, which we will update once the updated Code has been finalised.

Remedy 2 – Extension of Audit Quality Review (AQR) inspections and reporting

The Commission has recommended a significant extension to our AQR work, including that:

- all FTSE 350 audits be reviewed on average every five years with a maximum interval of seven years between inspections.
- reports be issued annually on all firms currently within our scope, where those firms audit sufficient Public Interest Entities (PIEs) for this to be practicable.

As previously advised, we are in principle willing to extend our coverage of the FTSE 350 as proposed, provided that we have sufficient flexibility to increase the frequency of inspections of more risky audits if we judge that to be necessary. This commitment is subject to us being able to secure the necessary increase in resource from the Recognised Supervisory Bodies (RSBs) on which the costs fall. Under current arrangements they will also be expected to provide increased funding to meet the requirements of the new EU audit directive and the government's plans for the FRC to take on local government audit. Subject to sufficient funding and resource being available, we plan to begin to increase the number of FTSE 350 inspections from 1 April 2014 and will aim to meet the Commission's target by the 2016-17 inspection cycle.

The Commission should be aware that currently only 332 companies in the FTSE 350 fall within our formal scope or are covered by other inspection arrangements (ie those with the Crown Dependency regulatory authorities). The others are primarily from elsewhere in the EEA, where the responsibility for inspection rests with the regulatory authority in the relevant country, or non-EEA companies without a UK auditor.

We intend to begin publishing annual reports on BDO and Grant Thornton in the first half of 2015 in relation to our 2014/15 inspection year. As noted in our response to the Commission's preliminary findings, at present the other firms within full scope (Mazars,

Crowe Clark Whitehill and Baker Tilly) do not audit sufficient PIEs to make annual reporting on them practicable. We would be inspecting only 2 – 3 audits per firm per year, which does not justify an annual report. On that basis we intend to continue with our current cycle of inspecting and reporting on these firms every three years. This policy will be kept under review and may change in the event of any of these firms gaining a significant number of PIE audits.

Remedy 4 – increased shareholder engagement on audit matters

The Commission has addressed two recommendations to the FRC:

- The Corporate Governance Code should be amended to require FTSE 350 companies to:
 - seek shareholder views on audit issues and state how any concerns identified as a result have been addressed; and
 - introduce an advisory vote for shareholders on the sufficiency of disclosure in the Audit Committee Report.
- The Stewardship Code should be updated to encourage institutional investors to engage with investee companies on audit issues.

We have previously advised the Commission that we are unclear what extra value these proposals will add to existing provisions in the Codes. The advisory vote does not appear to enhance significantly existing routes available to shareholders to express their views on the adequacy of the Audit Committee report. However, we will include the proposed changes in the consultation on the Code due to be issued in early 2014. Any implementation will depend on feedback received.

In order to provide stability for companies and investors we do not wish to review the Stewardship Code in 2014 and we are reluctant to consult on what is a relatively minor amendment. We therefore intend to hold over this proposed change until a later date, most likely 2016, when it can be included in a wider consultation. In the meantime, we will as part of our regular engagement with investors encourage them to take an interest in audit-related matters.

Remedy 5 – Increased Audit Committee oversight of the external audit

The Commission proposes to make an Order to the effect that in the case of FTSE 350 companies only the Audit Committee or its Chairman, acting on delegated authority from the Board, can:

- negotiate and agree audit fees and scope of work;
- initiate and supervise a tender process;
- influence the identity of an audit engagement partner; and
- authorise non-audit services.

The Commission states that auditors may only accept appointment to FTSE 350 companies if the terms are negotiated with and agreed by the Audit Committee, and that companies must monitor and certify compliance with the Order in the Audit Committee report.

The Commission has also recommended that the FRC revises the Corporate Governance Code in line with the Order.

The same point applies to this remedy as to remedy 1, ie we do not wish to change the comply or explain basis of the Code. In view of this we do not intend to amend the Code itself, which already contains provisions for the Audit Committee's oversight of the external auditor that are consistent with the proposed Order. Instead we will pick up the Order's additional specific requirements for Audit Committees in Guidance to Audit Committees.

We support the new requirement for auditors' acceptance of engagements but the change must be implemented through the Audit Regulations and the Commission should liaise with the RSBs, which have responsibility for the Regulations.

Remedy 6 – Disclosure of AQR inspection findings (including grade) in Audit Committee reports

The Commission recommends that we amend the Corporate Governance Code to include a new provision that Audit Committees of FTSE 350 companies should report to shareholders on the findings of any AQR review concluded during the reporting period, including the grade awarded and how both auditor and Audit Committee are responding to the findings.

We support the objective of increasing transparency. This remedy has the potential to encourage companies as well as their auditors to focus on our inspections and to act upon them. However, a number of issues need to be resolved:

- Confidentiality – currently we are restricted in the extent to which we can disclose the details of individual inspections because of our statutory confidentiality provisions. We are seeking independent legal advice on the implications of these provisions for the recommendation.
- Consistency – if the disclosure of grades and findings is undertaken solely by Audit Committees, they may be reported inconsistently and our findings summarised in an inappropriate manner.
- Risk – we need to ensure investors, analysts and the media do not assume that a poor inspection grade implies the accounts are unsound.

In short this is a complex area. Before determining exactly how to proceed we wish to ensure we have fully explored the issues and the views of market participants. We intend to include this recommendation in our 2014 consultation on the Corporate Governance Code. We also wish to seek the views of Audit Committees, investors and others on the current format of the AQR grading system and the descriptions of the grades. We will determine a way forward based on this consultation.

Remedy 7 – Secondary competition duty for FRC

The final remedy is a recommendation to the FRC to amend the objects clause in its articles of association so that, without prejudice to its other objects, in performing its functions it will have due regard to the need for competition in the statutory audit market for FTSE 350 companies.

There are a number of considerations which we are exploring in deciding how to proceed:

- The FRC is not a competition regulator and has limited competence in that area.
- Even as a secondary objective, the proposal risks creating a conflict with our responsibility to promote audit quality. Some firms may argue that we should not criticise them in our AQR reports as that could damage their ability to grow market share and enhance the competitiveness of the market.
- Regulation of the audit of FTSE 350 companies is only part of our work. We are considering whether a competition objective should cover all our work perhaps being cast in terms of promoting healthy, well informed competition for capital. This would be more aligned with our mission and statutory responsibilities.

We are keen to consult widely on this change and we plan to do so in the first half of 2014. Any change to our objects clause will be made in the light of the responses to that consultation.

If the Commission would find it helpful, we are happy to meet to discuss our proposed implementation of the remedies in more detail. Please let us know if this is something which you would like us to arrange.

Yours faithfully,



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Additional note (9/1/14):

In respect of the proposed disclosure of audit inspection outcomes by Audit Committees, the FRC wishes to undertake its consultation and reach conclusions on the issues before companies take action on their own account to disclose its inspection findings. The FRC is happy to discuss this with any Audit Committee chair.