COMPETITION COMMISSION

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of provisional decision on remedies

Notified: 22 July 2013

1. On 21 October 2011 the Office of Fair Trading (OFT) referred statutory audit services to large companies[1] in the UK to the Competition Commission (CC) for investigation under section 131 of the Enterprise Act 2002 (the 2002 Act).

2. On 26 February 2013 we issued our provisional findings report (provisional findings) in which we provisionally found an adverse effect on competition (AEC) arising from features preventing, restricting or distorting competition in the market for statutory audit services to large companies. Simultaneously with our provisional findings we issued a Notice of Possible Remedies (the Remedies Notice), which invited comments on the actions we might take, or recommend for others to take, to remedy, mitigate or prevent the AEC, or resulting detrimental effects on customers. On 5 June 2013 we published a Notice of supplementary remedies proposing a competition duty for the Financial Reporting Council (FRC).

3. This document presents our provisional decision on the package of remedies we think is required to remedy the AEC and resulting customer detriment. In reaching our provisional decision we have taken into account responses to the Remedies Notices, hearings and meetings, further submissions, and further analysis that we have conducted.

4. The main aspects of the remedy package that we have provisionally decided on are as follows:

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[1] 'Large companies' means companies that may from time to time be listed on the London FTSE 100 and FTSE 250 indices.

(a) FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. Companies may defer this obligation by up to two years if there are exceptional circumstances. There will also be a transitional period of five years before our tendering requirements come into full effect.

(b) The Audit Quality Review team (AQR) should review every audit engagement in the FTSE 350 on average every five years. The Audit Committee (AC) should report to shareholders on the findings of any AQR report concluded on its company during the reporting period, stating the grade awarded and how both the AC and auditor are responding to the findings.

(c) The AQR should review and report on the larger Mid Tier firms on an annual basis.

(d) Provisions in loan agreements which restrict a company's choice of auditor to certain categories or lists of statutory auditors should be prohibited.

(e) An advisory vote should be introduced on the sufficiency of the disclosures in the Audit Committee report section of the Annual Report (the Audit Committee Report); and amendments to the UK Corporate Governance Code and Stewardship Code made to further encourage shareholder engagement.

(f) Measures should be introduced to strengthen the accountability of the external auditor to the AC, including a stipulation that **only** the AC is permitted to negotiate and agree audit fees and the scope of audit work, initiate tender processes and make recommendations for appointment of auditors and authorize the external audit firm to carry out non-audit services (NAS).

(g) The FRC should amend its articles of association to include a secondary objective to have due regard to competition.

5. The remedy package includes measures to improve the bargaining position of companies and encourage rivalry among audit firms; measures to enhance the

influence of the AC in a company's relationship with its external auditors; and measures to promote shareholder engagement in the audit process. These remedies work in combination to promote competition and to ensure that competition is directed towards satisfying the demands of shareholders.

6. We consider that putting the statutory audit engagement out to tender more frequently will improve rivalry by ensuring that regular and well-informed assessments are made of whether a company's audit service is competitive. We found that tenders were thorough, fair, and transparent processes in which the AC had an influential role, ensuring that shareholder interests are given appropriate weight and which strengthen the incentives of audit firms to offer a competitive product.

7. We consider it to be a matter of judgement as to the appropriate interval between tender processes. We note the Financial Reporting Council's (FRC's) judgement that five years was the appropriate interval for rotation of an Audit Engagement Partner (AEP) to ensure their objectivity and independence and saw no grounds to alter it. We were persuaded of the benefits of aligning the interval between tender processes with AEP rotation, as this provides a break in the audit relationship at which the AC can make an informed choice of audit partner, and if it wants, switch audit firm without incurring more disruption than is necessary, and would limit the advantage that the incumbent firm derives from being able to offer an AEP with pre-existing experience of the company. This led us to choose between periods of five or ten years.

8. We think ten years too long a time for an audit engagement not to be subject to the high level of scrutiny and competition that that we found takes place within a rigorous tender process. In addition, and in line with the FRC's judgement that five years is the appropriate period for the safeguarding of objectivity and independence, we

consider that a period of five years would best ensure the sustained alignment of auditor incentives with shareholder (rather than management) demand. We do not consider from a competition perspective that an intra-firm partner rotation adequately secures this position. While partner rotation plays a legitimate role in ensuring that individual audit partners are objective and independent, it does not disturb the economic incentives of the audit firm and it is those firm-level incentives that our analysis is primarily concerned with.

9. Our provisional view is that five years is an appropriate interval at which to subject the audit relationship to scrutiny and challenge, and that going out to tender at this interval will increase company bargaining power and ensure a competitive service between tender processes. We think that companies should have an opportunity to defer going out to tender by up to two years where there are very strong reasons to do so.

10. The AC is an important part of the corporate governance architecture, and we place weight on its role in ensuring that competition takes place to satisfy the demands of shareholders. We consider that going out to tender on a regular basis will enhance the influence of the AC in the selection of the external auditor. We have provisionally decided to take further steps to increase the influence of the AC in the relationship with the external auditors. These steps include: enhancing the accountability of the auditor to the AC and enhancing the accountability of the AC to shareholders. The increased influence of the AC in combination with more frequent tender processes should help to ensure that competitive outcomes are achieved and that shareholders can be more confident that their interests have been at the forefront of any tender process and subsequent appointment decision, as well as throughout the ensuing audit relationship.

11. Information is important to the ability of shareholders to hold ACs to account in representing their interests, and our remedies in this area reinforce the FRC's recent changes to the Audit Committee Report and to ISA 700 to encourage greater disclosure by ACs and auditors. We have provisionally decided to require the AC to report on the results of any AQR during the period and to require companies to hold an advisory vote on sufficiency of the disclosures in the Audit Committee Report. We consider that these measures will encourage meaningful disclosure, promote high-quality audit, and enable shareholders to better appraise the effectiveness of the AC.

12. In designing an effective package of remedies, we have sought to ensure that the measures work in combination to produce the necessary incentives to ensure that competition works well. Our remedies designed to increase AC influence will work in combination with more frequent tender processes to ensure that competition is better focused on shareholder demand. Our remedy package will also promote information flow between companies and investors in relation to external audit and thus allow ACs to understand shareholder concerns better, and so better act on them.

13. We consider that our package of remedies is likely to increase choice, as both Big 4 and Mid Tier firms will have increased incentives to develop and expand their capabilities in order to win engagements. We consider that measures to prohibit restrictions on auditor appointment in loan agreements, in combination with more frequent tender opportunities, will encourage firms outside the Big 4 to invest in the capabilities necessary to win FTSE 350 engagements, particularly those lower down the scale of complexity and international breadth.

14. We have considered the role of the FRC carefully in formulating our remedy proposals, and we note that it has evolved over time into an agency that is increasingly well equipped to provide high-quality independent regulation to the audit

market. We found that the work of the AQR was well regarded, considered carefully by audit firms and companies, and so we found that it had an important role in promoting competition between audit firms. We welcomed the recent changes to the UK Corporate Governance Code to increase tendering and expand AC reporting, and changes to ISA 700 to expand auditor reporting, as we see them as beneficial steps towards promoting competition.

15. However, we considered that further steps were required to increase the resources of the AQR, and to encourage transparency of AQR grades. We considered that a change to the FRC's objects to have due regard to competition would ensure that it places appropriate weight on the role of competition in facilitating high-quality audit. We would necessarily be reliant on the FRC to take our recommendations forward, and to ensure that it secures the appropriate funding to facilitate this. In doing so we consider that the FRC will further strengthen its role as an accountable, transparent, and independent regulator of the audit industry.

16. We expect that the above measures taken together as a package will be effective and proportionate in remedying the AEC. We expect this remedy package to result in a substantially improved environment for competition in the FTSE 350 statutory audit market.

17. We are minded not to pursue the following remedies:

(a) Mandatory switching.

(b) Further constraining NAS provision by the auditor.

(c) Joint or major component audit.

(d) Shareholder group or FRC responsibility for auditor reappointment.

(e) Independently resourced Risk and AC.

18. We gave careful consideration to whether mandatory switching should be introduced. Our provisional view is that while mandatory switching would address concerns expressed by investors about very long tenures, our proposed remedy package addresses the AEC more effectively whilst delivering similar benefits and avoiding some of the costs associated with mandatory switching, and in particular the weakening of competition that would result from the incumbent firm being systematically excluded from the tender process. As a result, we have provisionally decided not to impose mandatory switching as a remedy to the AEC that we have provisionally found.

19. We have also decided against introducing measures to further constrain NAS, to further encourage or mandate joint/shared audit provision, to provide for shareholder or FRC appointment of auditors, and to establish an independently resourced Risk and AC. We decided that including any of these measures in our proposed remedy package would not add significantly to its effectiveness in addressing the AEC that we have found, and may add to the costs incurred.

20. We accept that the measures we are prescribing impose some additional costs, in particular on companies and on firms which we estimate to be less than £30 million per year in total when our tendering requirements come into full effect, and considerably lower in the initial five-year transitional period. These are small sums in relation to the combined market capitalization of the FTSE 350. On the other hand we consider that the benefits of our proposed remedy package are considerable. In our judgement, we think that an increase in competition and a refocusing of competition towards shareholder demand should increase audit quality and have important beneficial effects on shareholder value. We place considerable weight on the public benefits for the UK economy. An audit market in which shareholders can have increased confidence will assist in promoting the UK's corporate governance regime

as a centre of excellence and will encourage investment in UK companies. It is not feasible to quantify the size of such benefits with precision, however, in our considered judgement, they are likely to exceed the costs of our remedy package by a substantial margin.

21. In view of the above considerations, we have provisionally decided that our proposed package of measures represents as comprehensive a solution as is reasonable and practicable to the AEC and resulting customer detriment that we have provisionally found.

22. We invite views in writing on the provisional decision on remedies and its underlying analysis by Tuesday 13 August 2013. These should be emailed to: auditors@cc.gsi.gov.uk or sent to:

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23. This provisional decision on remedies is based on the AEC that we have provisionally found. We are continuing to consider the nature of the AEC and resulting consumer detriment, and will incorporate our views in our final report.