

Practical guide to corporate governance

Audit tendering - implementation and disclosure

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What's the issue?

In September 2012, the Financial Reporting Council ('FRC') made a number of changes to the UK Corporate Governance Code ('the Code') for premium listed companies, to apply for September 2013 year ends. Among the changes was the following provision:

"...FTSE 350 companies should put the external audit contract out to tender at least every ten years..."

[UK Corporate Governance Code provision C.3.7]

This change was made in the context of an international debate on the long relationships between some companies and their auditors and the perception that this could affect audit quality¹.

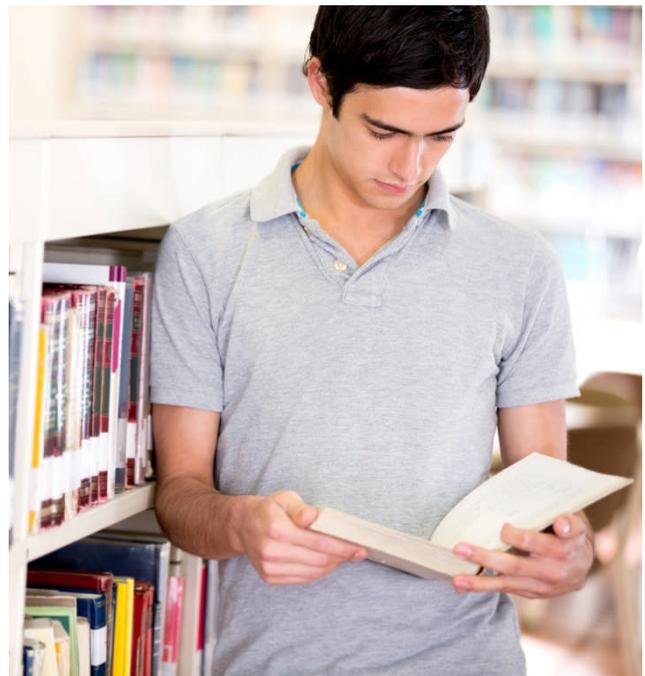
The FRC made it clear that, as with all other provisions of the Code, tendering was subject to the 'comply-or-explain' reporting mechanism. Its intention was not to introduce mandatory firm rotation, or mandatory tendering after a fixed period, and it stressed that the company and its shareholders should make the decision on which auditor to appoint and when to make a change.

"The purpose of holding a tender is for companies to benchmark the services provided by the incumbent auditor against those offered by other firms, with the aim of obtaining the best quality and most effective audit. If the company judges that this is best secured by reappointing the incumbent auditor, then that is what it should do."

[FRC Feedback Statement, September 2012]

There have been a relatively small number of tenders since the revised Code was published at the end of September 2012, though it is certain that tendering activity is increasing. In practice, we believe that companies, guided by their audit committees, have generally been willing to follow the FRC's intentions and, of the formal tenders that have taken place, several have resulted in the incumbent auditors being reappointed.

This paper looks at how companies have reported in connection with the tendering provision at year ends up to March 2013, to provide insight for those considering how to proceed when they report against the revised Code for the first time.



¹ The international debate has included proposals from the European Commission and, in the US, the Public Company Accounting Oversight Board.

Transitional arrangements

At the same time as the revised Code was published, the FRC issued 'transitional arrangements' on its website, recognising that 'the audit market could be disrupted if a large number of companies chose to go out to tender in the first year in which the revised Code applied'. These arrangements are reproduced below.

In essence, the arrangements tie the implementation of tendering to the next change of audit partner at the end of their five-year cycle, or to the point where the subsequent audit partner changes if the audit has been tendered since 2000. They are, however, non-binding and brief and do not attempt to deal in detail with the wide range of circumstances that companies face in implementing the new provision.

This paper also includes commentary on the status and use of the transitional arrangements.



Audit tendering

One of the new provisions in the 2012 edition of the Code states that FTSE 350 companies should put the external audit contract out to tender at least every ten years.

The FRC recognises that the audit market could be disrupted if a large number of companies chose to go out to tender in the first year in which the revised Code applied. When consulting on the proposal, the FRC therefore put forward some possible transitional arrangements. These were broadly endorsed and are set out below.

The suggested transitional arrangements are not binding. Companies should put the audit contract out to tender earlier than they would be expected to under these arrangements if they feel it is appropriate to do so, and shareholders should feel free to request them to do so. Equally, as with all other provisions of the Code, companies can choose not to comply and explain why not. Whatever their decision, the FRC would encourage companies to state when they first report against the 2012 Code whether or not they anticipate putting the audit contract out to tender in due course.

The FRC suggested that the timing of tenders might be aligned with both the cycle for rotating the audit engagement partner and the length of time since the audit contract was previously put out to tender. The FRC suggested that where a company has put the audit contract out to tender or changed audit firm in or after 2000, the tender process might be deferred until the latter stages of the incoming audit engagement partner's term (in other words, for a further five years).

So, for example, under these suggested arrangements, if the current audit partner was due to complete their five year period in 2014 the company would carry out a tender in time for the successful audit firm (which could be the incumbent firm) to take up their appointment when that partner steps down. However if the company had carried out a tender or changed audit firm more recently than 2000, this could be deferred until the next partner rotation in 2019.

[FRC website - Transitional arrangements]

How to address the issue

The FRC has been very clear that its priority is for companies to explain clearly their intentions in respect of the new provision.

“Whatever their decision, the FRC would encourage companies to state when they first report against the 2012 Code whether or not they anticipate putting the audit contract out to tender in due course.”

[FRC website - Transitional arrangements]

This is therefore the over-riding principle which all successful disclosures follow. We look below at how this has been done in a variety of circumstances².

Prior to implementation of the 2012 Code

Although there was no obligation to do so, even under the FRC's transitional arrangements, many companies indicated their intentions with respect to tendering at the 2012 year end, prior to their first report against the 2012 Code.

Imperial Tobacco plc

With its September year end, Imperial was a good example of applying the Code to the specific circumstances of the company in that the transitional arrangements suggested a tender for the year ending 30 September 2013, but the audit committee determined that this would not be in the best interests of the company and explained this very clearly. The explanation given also indicates that the committee will consider the new provision again during the tenure of the new engagement partner – perfectly reasonable given the shortness of time between the publication of the revised Code and Imperial's 2012 annual report:

PricewaterhouseCoopers LLP (PwC) have been the Company's Auditors since its demerger in 1996. The Audit Committee, following a review during the year, remains satisfied with the effectiveness and independence of PwC. It has not, therefore, considered it necessary to require the audit to be put out to tender. In line with our Auditor Independence Policy, the Group Audit Partner is required to rotate after a maximum of five years (seven years for subsidiary companies). The Audit Committee discusses engagement partner rotation with PwC on a regular basis and a succession plan is in place for David Charles to be replaced in 2013 at his normal rotation date after five years in the role. The Audit Committee will give further consideration during the incoming engagement partner's term to the application of the audit tendering provision of the recently published 2012 edition of the UK Corporate Governance Code. The Audit Committee considers that for a major international group these matters must be well planned to ensure that the Group complies with best practice corporate governance as well as ensuring the Group receives a high quality, efficient and effective external audit service. There are no contractual or similar obligations restricting the Group's choice of auditors.

[Imperial Tobacco Group PLC Annual Report 2012 page 69]

² Where companies have already gone to tender since the publication of the Code their intentions are clear. Examples of this include BG Group, Land Securities and Schroders, all of whom described the tender process in their most recent annual reports.

GlaxoSmithKline plc

GSK were in a similar position to Imperial Tobacco in respect of the transitional arrangements and rightly emphasised that the tendering decision will be subject to an annual reassessment³:

Audit partner rotation

The external auditors are required to rotate the audit engagement partner every five years. The current audit partner commenced his engagement on 1 January 2008 and will step down from his position after the audit of GSK's financial statements for 2012 has been concluded.

After a robust review process by the Committee, together with the involvement of the CEO and CFO to select his replacement, the Committee has approved the appointment of a new audit engagement partner with effect from the financial year commencing on 1 January 2013.

Audit firm tendering

PricewaterhouseCoopers LLP have remained in place as auditors since the Group's inception in December 2000 and the audit contract has not been put out to tender in the period. Their performance has been reviewed annually by the Committee since that time. As part of its review of the implications of the end of the current audit partner's five year term, the Committee considered the appropriateness of putting in place a tender process. This included assessing the FRC's most recent guidance on the subject, the level of change currently underway inside the Group and improvements to the auditors' services, including fee levels proposed by the auditors. The review concluded that a tender was not in the company's interests at this time and the Committee consequently approved the appointment of the new audit partner. However, the Committee agreed that this issue should be reviewed regularly as part of the annual appointment process.

[GSK Annual Report 2012 page 105]

It is notable from these explanations that the companies reserve the right to make their own decisions on the timing of future tenders, but all imply strongly that compliance with the Code provision is likely within a few years. We believe that this is the indication that the FRC is seeking.

³ The 2012 Code (provision C.3.8) requires the audit committee to report "... how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted..."



After implementation of the 2012 Code

Very few companies have yet implemented the 2012 Code to the extent that they have reported formally on compliance with it⁴. Most have reported against the existing 2010 Code and noted where they have implemented elements of the revised Code.

Barclays plc

Barclays was, however, one company that did report formally in its compliance statement against the 2012 Code:

Statements of Compliance

UK Corporate Governance Code

As Barclays is listed on the London Stock Exchange, we comply with the UK Corporate Governance Code (the Code). A revised code came into effect in 2012, applying to financial years beginning on or after 1 October 2012. Having adopted some of the provisions of the Code early, Barclays has chosen to report in this report as though the revised Code was in effect throughout 2012. For the year ended 31 December 2012, we have complied with the relevant provisions set out in the Code and applied the principles of the Code as described in this report, except as disclosed below:

- Provision A.2.1 of the Code requires that the roles of chairman and chief executive are not exercised by the same individual. For a period during July and August 2012, Barclays was without a Chief Executive and Marcus Agius, the then Chairman became full-time Chairman and Chairman of the Executive Committee. The terms of Mr Agius's appointment as full-time Chairman provided that he could not exercise any executive powers without prior discussion with the Executive Committee. The appointment of Mr Agius as full-time Chairman was a short term measure pending the appointment of a new Chief Executive and, during this time, Barclays maintained a strong non-executive Director element on the Board, including a Deputy Chairman, who was appointed in July 2012.*
- Provision D.2.2 of the Code requires that the remuneration committee should have delegated responsibility for setting remuneration for the Chairman. The remuneration for Sir David Walker, who was appointed as Chairman during 2012, was set by the non-executive Directors, led*

by Sir John Sunderland, Chairman of the Board Remuneration Committee, as part of the process of appointing the new Chairman. Barclays does not consider this to be any less effective than delegating the question of the Chairman's remuneration to the Board Remuneration Committee.

Provision C.3.7 of the Code requires that the external audit contract is put out to tender at least every ten years. This requirement is a new provision in the Code that applies for financial years beginning on or after 1 October 2012. Barclays external audit contract has not been re-tendered at any time in the past ten years. Given the complexity of the Barclays audit and the significant work that would be involved in putting the audit out to tender, Barclays is considering how it might comply with this provision in future, taking into account the non-binding transitional provisions suggested by the FRC which were issued along with the revised Code.

[Barclays PLC Annual Report 2012 page 61]

The explanation in connection with the tendering provision (C.3.7) in this statement of compliance does not explicitly recognise it as an instance of non-compliance with the Code. This could be partly because the tendering provision comes from the 2012 rather than the 2010 Code (i.e. not the Code referred to in the Listing Rules), but it also reflects the fact that the company is 'taking into account the non-binding transitional provisions suggested by the FRC'. In other words, under the transitional arrangements, Barclays would not yet be expected to go to tender, so it is taking time to consider its approach to implementing the new provision. In the audit committee report it is also stated that 'a recommended course of action will be proposed to the Board during 2013'.

Taken together, we believe this approach is in line with the FRC's intentions. The company has:

- Recognised that the Code requires only that the audit be tendered at least every ten years;
- Referred to the transitional arrangements to determine the suggested deadline for a tender; and
- Explained how it intends to proceed, with a view to deciding *how* it will comply not *whether* it will comply. Because of the shortness of time between the publication of the Code and the year end the audit committee's advice to the Board will be in 2013, but the overall intention is clear.

⁴ Although the Listing Rules still refer to the 2010 version of the Code the 2012 Code simply adds to the earlier version, so we do not see an issue in 'early adoption'.

Our view is that Barclays are right to treat provision C.3.7 as first and foremost a matter to be explained, and also right not to claim full compliance with the Code before they can state that a tender has occurred within the last ten years. The FRC's transitional arrangements are not part of the Code itself and applying them does not override the Code provision.

National Grid plc

National Grid also reported against the revised Code at their 31 March 2013 year end. Their situation differs from Barclays in that they had no instances of non-compliance to report. Again, we believe that their approach is in line with the FRC's intentions. Their compliance statement reads as follows:

Compliance statement

The Board considers that it complied in full with the provisions of the UK Corporate Governance Code 2010 (the Code) and, additionally, the new edition of the UK Corporate Governance Code 2012 (the new Code) during the financial year being reported taking account of the transitional arrangements suggested by the Financial Reporting Council for external audit tendering.

[National Grid plc Annual Report 2013 page 58]



The transitional arrangements are then picked up in the audit committee report, in a section which makes it clear that the company intends to implement the provision, and that the latest date will be as suggested in the transitional arrangements.

Audit tender

PwC have been the Company's external auditors since the merger with Lattice Group plc in 2002, having been the incumbent external auditors of both the merging parties. The new Code requires FTSE 350 companies to put the audit services contract out to tender at least once every ten years, to enable the committee to compare the quality and effectiveness of the services provided by the incumbent auditors with those of other audit firms. Transitional arrangements provided by the Financial Reporting Council indicate the Company should tender the audit, at the latest, at the time of the next audit partner rotation currently scheduled for 31 March 2015.

We may, however, put the audit out to tender at any time before this date. There are no contractual obligations restricting our choice of external auditors and no auditor liability agreement has been entered into.

[National Grid plc Annual Report 2013 page 65]

Conclusion

The introduction of the audit tendering provision has already increased the profile of audit tendering, and we believe that there will be much more tendering activity in the years to come than we have seen historically – i.e. companies will move towards compliance with this new Code provision, as they mostly do with all its other provisions.

Unless they have tendered in the past ten years, companies will need to comment in their compliance statements in connection with the new provision, either referring to the transitional arrangements or otherwise explaining their approach.

Taking into account the examples in this report, we would suggest wording such as the following where the company is following the transitional arrangements:

“The Board considers that the company has complied with the provisions of the 2012 version of the UK Corporate Governance Code having had regard to the transitional arrangements for external audit tendering published by the FRC”.

We are encouraged to see that audit committees and boards have put the interests of the company above compliance or perceived market pressure, making decisions on the basis of obtaining the best quality and most effective audit.

We are also encouraged by the quality of the explanations of companies’ approach to the tendering provision, even in advance of applying the rest of the 2012 Code; these generally demonstrate a sensible approach to reporting and the use of the transitional arrangements and an appreciation that the FRC and the market are more focussed on the company’s intentions than immediate compliance.

Further information

Please enquire of your usual PwC contact or:

Andy Kemp

Tel : +44 (0) 20 7804 4408

Email: andy.kemp@uk.pwc.com



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