

Competition, transparency and quality – the Competition Commission’s provisional remedies

On 24 July the Competition Commission (CC) issued the full text of its provisional decision on remedies to be applied in the FTSE 350 audit market following its provisional findings that adverse competitive effects exist in that market.

The Competition Commission has proposed:

- Audit appointments in respect of FTSE 350 companies should be subject to mandatory re-tendering every 5 years (with a possible extension to 7 years in certain circumstances);
- The Audit Quality Review (AQR) team should review every audit in the FTSE 350 every 5 years, with the findings and grade to be reported to shareholders;
- Increased accountability of the auditor to the audit committee;
- A shareholder advisory vote on the annual Audit Committee Report;
- The Financial Reporting Council (FRC) should be given a secondary objective to have due regard to competition; and
- So-called “Big 4” clauses in loan agreements should be prohibited.

“This is a significant package of proposals that focuses on competition, transparency and quality. Some commentators have said that the CC has not gone far enough. We don’t agree. The CC has suggested a number of remedies which will improve transparency between the auditor, audit committees, regulators and investors, enabling investors better to understand and voice their opinion on the performance of the auditor and the audit committee.

We are pleased to see that, after careful and detailed consideration of the evidence and listening to the concerns of the market, the Competition Commission has rejected mandatory rotation, any further restriction on non-audit services and joint audits.

It’s disappointing that the Competition Commission have provisionally decided to mandate tendering every five years, only nine months after the FRC introduced its game changing ten year tendering regime. It is too early to conclude that the current FRC tendering regime isn’t working. Practical experience suggests it is promoting change. To shorten the period now is not justified and would create a significant burden on business.”

James Chalmers, PwC UK Head of Assurance

These are provisional remedies and the Competition Commission has invited any interested party to respond by 12 August. Companies with recent experience of tendering will be especially well placed to comment.

Competition

We believe that the UK audit market is highly competitive and the introduction by the FRC of 10 year tendering of audits on a “comply or explain basis” is resulting in a significant step up in tendering activity. We are expecting at least 50 audit tenders in each of the next two years.

Mandatory tendering

The CC has proposed that a regime of mandatory audit tendering should be introduced, with FTSE 350 audit appointments to be re-tendered every five years. In certain circumstances, companies would be able to defer this obligation by up to two years.

We do not believe that nine months is enough time to conclude that the FRC’s ten years “comply or explain” regime isn’t working. Nor do we believe that the CC has compelling evidence to support its decision to drop the tendering period to five years. The proposal would create a significant additional cost for business at a time when economic growth is paramount, probably much higher than the CC’s estimate of £30m. There is also the risk that such frequent tendering means that the process becomes perfunctory and has the opposite effect to that which the CC are trying to achieve.

The CC recognises that the period between tenders is a matter of judgment. In our view, this is a judgment for the audit committee. In this remedy and others the CC have moved away from the long-standing British tradition of “comply or explain”. The CC intends that tendering should be genuinely mandatory, with only limited grounds for deferral. We believe that “comply or explain” is a fundamental tenet of UK governance which encourages responsible corporate behaviour with full transparency to shareholders.

A new objective for the FRC

The CC proposes that the FRC should have a secondary objective to have due regard to the need for competition in the FTSE 350 audit market. The experience of the financial services regulators, who have similar secondary competition objectives, shows that practical application is difficult. However, we support the change, as long as the competition objective is clearly subordinate to the FRC’s work to maintain audit quality.

Given this new FRC objective, we believe that a better response to tendering would be for the CC to require the FRC to review the effectiveness of its 10 year tendering regime after the first tendering cycle is completed. At that point, the FRC could, if it felt necessary, make changes.

Transparency

Shareholder voice

The CC’s proposals encourage the engagement of shareholders in the audit process. The CC suggests an advisory vote be introduced on the sufficiency of disclosures in the Audit Committee Report section of companies’ Annual Reports, together with further amendments to the UK Corporate Governance Code and Stewardship Code. We support these remedies and look forward to increased engagement with shareholders in the future.

Quality

Audit Quality Review

The CC recommends that the AQR team of the FRC should review every audit engagement in the FTSE 350 on average every five years. Audit committees will be required to report to shareholders on the findings of AQR reports, stating the grade awarded and how the audit committee and auditor are responding to the findings. The larger mid-tier audit firms will also be subject to AQR review on an annual basis.

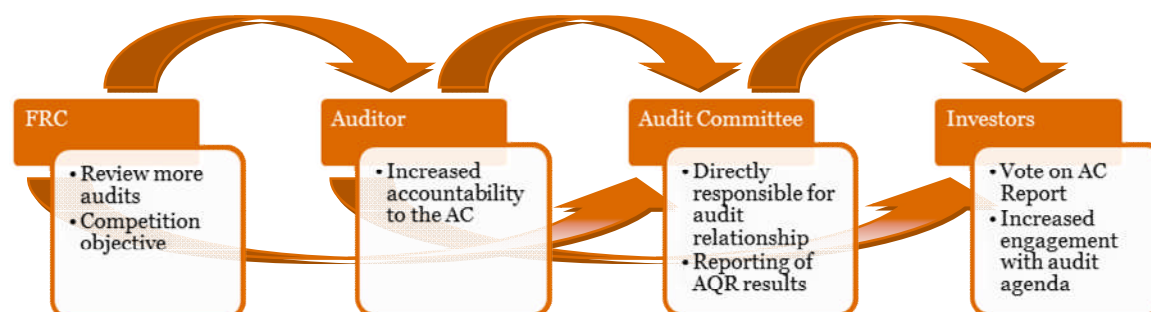
These proposals will place a substantial additional burden on the FRC; its current resource levels could not accommodate the changes. The CC has suggested that the cost of these changes could be funded directly by FTSE 350 companies. It will be important for the FRC to build a sustainable structure for delivering this remedy to ensure that the quality of its review is not compromised in the interests of volume.

The market will also need to adjust to the impact of scrutiny of matters that until now have been discussed only between auditors and audit committees.

Increased accountability of the auditor to Audit Committee

Measures are proposed which strengthen the accountability of the external auditor to the audit committee, including a requirement that **only** the audit committee will be permitted to negotiate audit fees and scope, require replacement of the lead audit partner, initiate and conclude on tenders and authorise non-audit services. Today's best practice audit committees already follow many of these protocols.

Threading together the assurance chain



Most of the CC's remedies work together coherently, as illustrated in the diagram. They thread together the different links of the assurance chain. This will result in more transparency over the audit process, and over audit quality, than has ever existed.

The changes to the external audit report, implemented earlier this year in the FRC's ISA 700, support this move towards greater understanding of the audit process. We hope that investors will take the opportunity to engage with the audit agenda, asking questions of auditors at AGMs and challenging audit scoping.

What did the CC reject?

The CC has decided against proposing remedies such as mandatory firm rotation, restrictions on non-audit services and the imposition of joint audits. We have long argued against these remedies because of their adverse effect on competition, choice and audit quality. We welcome the CC's conclusions in this regard.

The debate on mandatory firm rotation continues at the European Union level. We hope that the CC's clear statement that mandatory firm rotation weakens competition will be influential in that debate.

What happens next?

Responding to the CC's provisional decision

The remedies proposed by the CC remain provisional and the CC has invited interested parties to respond to the proposals by 12 August. The CC also has a limited amount of analysis outstanding which we expect to be completed soon.

During the second half of August and September the CC will consider the responses received, not only regarding its provisional decision on remedies, but also to its provisional findings on competition in the statutory audit market, issued in February this year. Later in September, and certainly before the statutory deadline of 20 October, we expect the CC to issue its final report, containing its conclusions on the operation of competition within the statutory audit market, and the remedies it considers necessary in response. Those remedies will then be formalised, with the terms of any order finalised following consultation over a period of up to nine months.

Transitional arrangements

Most of the proposed remedies will not involve complex transitional arrangements. Changes are likely to take effect as of October 2014 given the time needed for further discussion and consultation pre-implementation.

The introduction of a five year mandatory tendering regime would, however, create significant transitional challenges. At present, the CC is proposing a five year transition period, to be applied as set out below:

- Where a company last tendered its external audit appointment before 1 January 2005, it should initiate a competitive tender at the point its lead audit partner is due to rotate;
- Where a company has undergone an audit tender since 1 January 2005, it does not have to initiate a competitive tender at rotation of the current lead audit partner. Tendering becomes mandatory at the end of the following five year rotation period.

A final word

We will be responding to the CC's proposed remedies, explaining the areas we think work well, and those where we think an alternative approach is needed. We encourage all interested parties to do the same.

PwC contacts:

James Chalmers – Head of Assurance

james.chalmers@uk.pwc.com 0207 213 5501

Gilly Lord – Head of Regulatory Affairs

gillian.lord@uk.pwc.com 0207 804 8123

Press enquiries – Emma Thorogood

emma.thorogood@uk.pwc.com 0207 213 8593

