

JEB/MB

Inquiry Manager
Audit Market Investigation
Competition Commission
Victoria House
Southampton Row
LONDON
WC1B 4AD

By email: auditors@cc.gsi.gov.uk

21 March 2013

Dear Sir/Madam

Audit Market Investigation – Provisional Findings Report

ICAS (The Institute of Chartered Accountants of Scotland) welcomes the opportunity to comment on the Competition Commission's (CC) provisional findings of its inquiry into the FTSE 350 audit market.

ICAS' Charter requires us to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount

Our members cover the complete spectrum of senior positions in corporate life; from executive directors in listed companies, including Chief Executives and Finance Directors; non-executive directors including Chairmen and Chairs of Audit Committees; to audit, assurance and specialist partners in accountancy firms and senior positions in public bodies, central and local government and including regulators. We also have many members who work in the fund management industry and therefore comprise some of the investors referred to in the CC report. We have a constant dialogue with our members and it is from their views and practical experiences that we draw our response.

We would be happy to meet to discuss our comments if you would find this to be helpful to concluding your inquiry. We have responded separately to the CC's notice of potential remedies.

General Comments

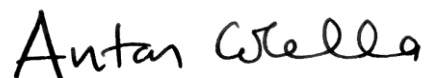
- ICAS welcomes and acknowledges the depth of work that the CC has undertaken in relation to this inquiry.
- We are pleased to note that the CC accepts that most audits are performed diligently however we do question its belief that "... *auditors tend to focus on management interests over those of shareholders.... management may have incentives to present their accounts in the most favourable light whereas shareholder interests can be quite different*". Our evidence from speaking to members of audit committees is rather different and shows that auditors are very much aware of their primary responsibility to shareholders.

- We are not convinced that the CC has produced sufficient appropriate evidence to justify its comment: *“the lack of competition is likely to lead to higher prices, lower quality and less innovation for companies and a failure to meet the demands of shareholders and investors”*.
- It is also not clear from the report what the primary problem is that the CC has identified that needs to be rectified. This is an important point because, without a clear enunciation of the problem, it is difficult to assess the efficacy and effectiveness of the ‘solutions’ proposed.
- Certain firms build up concentrations of industry expertise in certain markets. All the firms are not equally as strong in all sectors in all markets. Therefore, we call into question the CC’s apparent assumption that the FTSE 350 market is homogenous.
- As we highlight in our response to the CC’s notice of possible remedies, there is a need to assess the potential impact of the remedies being considered on audit quality. It is not clear that this most important criterion has been given sufficient consideration by the CC in its deliberations to date.
- The Financial Reporting Council (FRC) has only recently introduced a provision in the UK Corporate Governance Code that FTSE 350 companies should retender their external audit every ten years on a ‘comply or explain’ basis. The anecdotal evidence would suggest that this has led to greater consideration being given by boards of directors of the need to consider putting the audit out to tender. Several high profile changes of auditor have already taken place in recent weeks and other major corporates have either publicly announced that they are putting their audit out to tender or are giving serious consideration to doing so. This is quickly establishing an expectation in the market that retendering and, in all likelihood rotation, will occur more frequently – which in turn puts pressure on any company not preparing to retender within the timescale. In the light of these developments we do not see the need for the CC to recommend the introduction of more frequent retendering or indeed mandatory rotation of the audit firm at the present time.
- Tendering and rotation of audit firms are not cost free exercises for either side and there is a need for the CC to produce clearer evidence of the problems that it believes exist in the marketplace and need to be corrected.
- We are not convinced that there is a lack of competition in the FTSE 350 audit market although we do accept that there might be certain sectors where the level of choice is rather restricted because of limitations in expertise and/or geographical coverage in one or more firms.
- We do not accept the accusation of lower audit quality. The audit committee chairs that we have spoken to, have informed us of instances which have clearly highlighted the independence of the auditors and their need to ensure that audit quality, and not satisfaction of executive management, remains at the forefront of their minds. Likewise, audit committee chairs have highlighted that audit innovation does take place, although much of this might not be visible to the ultimate beneficiaries i.e. the shareholders. We are also aware that audit committees, as well as boards in general, do push for value for money from the auditors.
- Board Chairmen, and their Audit and Remuneration chairs in FTSE 350 companies find it difficult to meet with the governance groups within major shareholders to discuss issues of common concern. In general the governance groups within the investment community appear to be under-resourced and primarily focussed on other matters such as remuneration, voting etc.

Our comments on the CC’s provisional findings in relation to the relevant features of the market can be found overleaf.

We would be happy to meet to discuss our comments if you would consider this to be helpful to you in concluding your inquiry. We have also included a copy of relevant supporting documentation in our response. If you have any matters you would like to discuss further, please contact David Wood, Executive Director, Technical Policy & Services, or James Barbour, Director, Technical Policy, in the first instance.

Yours faithfully

A handwritten signature in black ink that reads "Anton Colella". The signature is written in a cursive, flowing style.

Anton Colella
Chief Executive

CC's Provisional findings – Relevant Features of the Market

(a) Barriers to switching:

- (i) companies face significant hurdles in comparing the offerings of an incumbent firm with those of alternative suppliers other than through a tender process;**
- (ii) it is difficult for companies to judge audit quality in advance due to the nature of audit;**
- (iii) companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship.**

We are not convinced that companies face significant hurdles in comparing the offerings of an incumbent firm with those of alternative suppliers other than through a tender process. Most FTSE 350 companies will use several accountancy firms to provide them with a range of professional services other than audit. They will therefore, at least to some degree, have knowledge of the quality of the personnel that work for other such providers. This at least provides a starting point for assessing the quality of other firms that might be engaged as auditor in the future. Indeed, an audit committee may well consider using the services of an accountancy firm in a non-audit capacity as a precursor to inviting them to tender for the external audit at a future date. Furthermore, the Financial Reporting Council's audit monitoring reports are publicly available on all of the larger audit firms. The information that is available to companies therefore discounts the notion that they have no idea of what quality to expect from the other firms when compared with the current incumbent audit firm.

We would agree that there has been a certain degree of inertia in relation to companies within the FTSE 350 changing an auditor. However, this overlooks the fact that the board of directors and in particular, the audit committee assess their satisfaction with the quality of the external audit on at least an annual basis. To discount this fact does a major disservice to the individuals who currently sit on the audit committees of companies in the FTSE 350. Additionally, the introduction by the FRC of the provision that FTSE 350 companies should retender their audit every ten years on a 'comply or explain' basis is having an impact in the marketplace. In our view, audit quality is at the forefront of the minds of those who sit on audit committees. Whilst audit quality is a rather nebulous concept those who are closest to the audit are best placed to make an assessment of the factors which contribute to a quality audit and to assess the level of professional scepticism and challenge that the auditor has presented to executive management. The evidence that has been presented to us indicates that considerable discussion and challenge takes place between the audit committee and the external auditor.

The provisional report from the CC in our view fails to properly take on board the shift in the balance of power that has taken place on such matters on boards from the executive directors to the non-executive directors. It is our belief that non-executive directors are very clear that their responsibility lies not to executive management but rather to shareholders. We also beg to differ in relation to the assumption that companies lack bargaining power. As noted above, companies in the FTSE 350 all use other professional accountancy firms other than the auditor to provide certain non-audit services e.g. taxation, internal audit etc. They are therefore well capable of deriving approximate charge out rates that are applied by these firms and thereby estimating a likely ballpark figure as to how much another firm would demand for undertaking the external audit.

So, whilst we agree that there is a reluctance to change auditor where there is no good reason to do so, we do not agree that companies find it difficult to compare alternatives and that they lack bargaining power. We also believe that boards of directors feel in the current climate that they at least need to consider the possibility of putting the company's audit out to tender. The anecdotal evidence suggests at the moment that this is very much the case and we have already seen certain major FTSE companies announce a change of auditor in recent weeks as well as other high profile companies publicising the fact that they will be tendering their respective audits.

We would also highlight that boards are not just driven by the desire to lower the audit cost, they are also seeking to improve the quality and effectiveness of the process. Management and Audit committees wish to derive value from the exercise e.g. improved corporate reporting often by picking up examples of best practice which the auditors have seen elsewhere. Boards when they have made the decision to retender and, more importantly, are prepared to actually change auditors, rarely go for the lowest bidder.

(b) Company management face significant opportunity costs in the management time involved in the selection and education of a new auditor.

It is undoubtedly the case that there are costs to companies in switching from one audit firm to another. The extent of those costs will undoubtedly vary from company to company with factors such as size, geographical spread and complexity of operations of the entity having an impact. The main cost is that a properly run tender will take up considerable management and staff time. This in itself can act as a barrier to putting the audit out to tender. Furthermore, for some companies the audit committee might be happy with the quality of the audit and may be focussing its attention on what it perceives to be more important pressing risk management issues. Despite this, there is already a provision which has recently been inserted into the UK Corporate Governance Code that FTSE 350 companies should retender their audits every 10 years on a 'comply or explain' basis. In our view the FRC thought long and hard before making this change to the Code and it should be given time to bed in before any further requirements for more regular retendering are introduced. We are also aware that the mood in many corporates is changing with the view becoming more prevalent that more regular tendering is the way ahead. Shareholders also have the opportunity to put greater pressure on to audit committees if they desire to see more regular retendering or indeed more regular rotation. We believe that such market led developments are to be encouraged as shareholders are ultimately the beneficiary of the audit process.

(c) Mid Tier firms face experience and reputational barriers to expansion and selection in the FTSE 350 audit market.

The current FTSE audit market would suggest that this is undoubtedly an issue as the vast majority of the audits of FTSE 350 companies are undertaken by the Big Four audit firms. However, in our view there is no easy appropriate mechanism that can be introduced that would allow a firm outwith the Big Four to gain greater market share of the FTSE 350 market. We are supportive of the FRC's change to the UK Corporate Governance Code which means that such companies will need to put their audit out to tender on a more frequent basis or explain their decision not to do so. However, we are aware that there remains a sense amongst certain audit committee chairs in certain sectors of the FTSE 350 market that the level of global coverage, particularly in certain emerging economies, offered by firms outside of the Big Four remains an issue for businesses which are truly global and have operations in various countries around the world. We therefore support amending the existing UK Corporate Governance Code provision slightly, to the effect that FTSE 350 companies should invite at least one non Big-4 firm to tender for their audit in a bid to increase the likelihood of mid-tier firms winning greater market share in the FTSE 350 audit market.

(d) Auditors have misaligned incentives, as between shareholders and company management, and so compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ.

We do not support this view and believe that this statement completely fails to take account of what is actually happening in practice. The auditor's primary role is to report on the company's financial statements to the shareholders. They take this role very seriously and are well aware of the potential punitive liability, regulatory and reputational consequences of getting it wrong, which could have a serious and in certain circumstances, catastrophic impact on both the career of the individual partner concerned and the very existence of the audit firm. The statement also fails to take on board the shift in power in this area in UK boardrooms from the executive directors to those non-executive directors on the audit committee. The audit committee plays a vital role in the external audit process with regular engagement between audit committee chairs and audit

engagement partners providing both parties with ample opportunity to discuss any concerns. The non-executive directors that we have spoken to are very clear that their responsibility is to the shareholders. We believe that most non-executives are fully aware that shareholder views are increasingly sought by Chairmen before they make board appointments. There are numerous examples today of non-executive candidates finding it difficult to attract new appointments if they are seen to have been on boards of companies where shareholders lost money. To them, their reputation is fundamental. Audit committees therefore, are well versed in the fact that audit quality must remain at the top of their agenda. Indeed we are aware of circumstances where audit committees have sought to support the views of the external auditor as opposed to executive management in relation to the accounting treatment of certain transactions.

(e) Auditors face barriers to the provision of information that shareholders demand (in particular from the reluctance of company management to permit further disclosure).

We are not aware of any such barriers. As per section 393 of the Companies Act, directors of the company must not approve a set of accounts unless they are satisfied that the accounts give a true and fair view of the company's financial performance and position. The auditor is then required to opine on whether the accounts as presented show a true and fair view. We therefore believe that auditors will, and indeed do, ensure that the information that is necessary to show a true and fair view is included in the financial statements.

We do however accept that shareholders are now demanding even greater insight into the key risks and challenges faced by the entities in which they are investing. We therefore welcome that the CC is considering calling for extended reporting requirements although discussion is required as to the additional subject matter to be disclosed. In December 2010, ICAS published its 'Future of Assurance' report. This report recommended that more information should be communicated to stakeholders via the annual corporate report. The preferred mechanism for delivering that information at that time was via the audit committee report to provide a greater understanding of the function of the audit committee and how they had discharged their duties including discussion of key issues and concerns arising from the audit. The Working Group recommended that:

"A more transparent audit committee is achieved through greater disclosure of its activities. An expanded audit committee report is required and should include: A matrix-style report which maps the key risks disclosed by the Board in its report to the assurance processes used to gain assurance over those risks: A substantive discussion of how the audit committee satisfied itself of the appropriateness of management's judgements: Details of the key areas discussed between the audit committee and the auditors, including the main areas of audit challenge."

We therefore welcomed the recent change to the UK Corporate Governance Code that will require more informative reporting from audit committees.

The Working Group also recommended that additional reporting should be required of the auditor but was very much of the view that in the first instance the catalyst for enhanced reporting should come from the directors of the entity. The document can be downloaded at: <http://icas.org.uk/futureofassurance/>.

Since the publication of the report, ICAS is aware of the general move towards seeking to include more and better information in the auditor's report. ICAS notes and appreciates the work that the International Auditing and Assurance Standards Board and FRC have done in this space in relation to seeking the views of institutional investors and other interested parties. ICAS is supportive of the ultimate aim of enhancing the quality of information that is made available to shareholders and other stakeholders via corporate reports but believes that this aim can only be achieved by better reporting by both the entity and the auditor.