

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Draft explanatory notes – Formal Consultation

The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014

This note is not a part of the Order

Introduction

1. The Competition Commission (CC) published its findings in a report under section 136 of the Enterprise Act 2002 (the Act) entitled *Statutory audit services for large companies market investigation: a report on the provision of statutory audit services to large companies in the UK* and notified on 15 October 2013 (the Report).
2. The Report set out the CC's findings that there are features of the market for statutory audit services for large companies which adversely affect competition.
3. The CC decided on a package of remedies to address the adverse effect on competition and the consequential detrimental effects on customers identified in the Report. The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 gives effect to part of these remedies whilst taking into account the provisions of Regulation (EU) No 537/2014 (the Regulation) which governs the audit of public interest entities (PIEs) including FTSE 350 Companies.
4. On 1 April 2014, the functions of the CC transferred to the Competition and Markets Authority (CMA) by virtue of the Enterprise and Regulatory Reform Act 2013 and the Enterprise and Regulatory Reform Act 2013 (Commencement No 6, Transitional Provisions and Savings) Order 2014.
5. This Order applies in relation to Financial Years beginning on or after 1 January 2015. Unless otherwise stated, it is not intended that there should be any further transitional period in relation to any of the provisions contained within the Order.

Possible consequences of not complying with the Order

6. Section 167 of the Act places a duty on any person to whom this Order applies to comply with it. Any person who suffers loss or damage due to a breach of this duty may bring an action.
7. Section 167 of the Act also provides that the CMA can seek to enforce the Order by civil proceedings for an injunction or for any other appropriate relief or remedy.

Review of this Order

8. The CMA has a duty under section 162 of the Act to monitor the operation of the Order. This includes a duty to consider, from time to time, whether the Order should be varied or revoked in the light of a change of circumstances. Article 9 of the Order requires any person to whom this Order applies to provide the CMA with information to allow it to monitor and review the operation of the Order.
9. It is intended that this Order will continue to apply beyond the application date of the Regulation and that implementation of derogations permitted by the Regulation will require minimal changes to this Order.

Status of this explanatory note

10. Nothing in this explanatory note is legally binding. In the event of a conflict between this explanatory note and any provision of the Order, the Order shall prevail.

Structure of the Order

11. The Order is divided into nine parts:
 - Parts 1 and 2 contain general provisions, which include specifying when the Order comes into force, the scope of the Order and definitions that are used throughout the Order (and which are also used in this explanatory note)
 - Part 3 prohibits an Auditor and a FTSE 350 Company from entering into or giving effect to a Statutory Audit Services Agreement unless certain conditions are met
 - Part 4 contains provisions regarding the use of Competitive Tender Processes

- Part 5 contains provisions regarding Audit Committee responsibilities
- Part 6 contains transitional provisions regarding the mandatory use of Competitive Tender Processes
- Part 7 contains an obligation on FTSE 350 Companies to state compliance with the Order
- Part 8 contains provisions allowing the CMA to give directions as to compliance with the Order
- Part 9 relates to the provision of information to the CMA for the purposes of monitoring compliance with the Order and reviewing its operation

Scope of this explanatory note

12. This explanatory note deals with each of the articles in the Order. Terms used in a particular article are generally defined in that article.

Part 1 – General

13. This provides that the Order applies to the provision of Statutory Audit Services in the UK and that the Order applies in relation to Financial Years beginning on or after 1 January 2015.
14. In view of the fact that the FTSE 100 and FTSE 250 indices incorporate a shifting class, with Companies periodically moving in and out of the listing, Article 1.3 provides that a Company is bound by the Order on entry into either index until such time as it exits both indices.
15. In the Report we indicated that new entrants to the indices should be subject to the Order immediately upon entry. We consider that the provisions of the Order reflect good corporate governance which Companies that aspire to join either index are likely to follow, and in any event, the requirements of the Order can be taken into account and planned for by Companies outside the FTSE 350 listing.

Part 2 – Interpretation

16. Article 2 contains the definitions for the capitalised terms used in the Order.
17. Some key definitions are ‘Auditor’, ‘Auditor Appointment’, ‘Audit Committee’, ‘Competitive Tender Process’, ‘FTSE 350 Company’, ‘Statutory Audit’:

- (a) **Auditor** – means a person eligible for appointment as statutory auditor under Part 42 of the Companies Act (this includes individuals and Firms). Part 42 of the Companies Act makes provision for the necessary qualifications and proper supervision of auditors, including auditors appointed under Part 16 of the Companies Act.
- (b) **Auditor Appointment** – means the appointment of an Auditor under Part 16 of the Companies Act.
- (c) **Audit Committee** – The Companies Act defines Audit Committees by reference to Directive 2006/43/EC. The Audit Committee’s role is to, inter alia, monitor the financial reporting process, monitor the Statutory Audit of the annual and consolidated accounts and review and monitor the independence of the auditor. The UK Corporate Governance Code contains further provisions regarding the role of Audit Committees and provides that an Audit Committee should usually consist of three non-executive directors at least one of which has recent and relevant financial experience.
- (d) **Competitive Tender Process** – for a valid Competitive Tender Process to take place, the Company must invite at least two Auditors (which may include the Incumbent Auditor) to compete for the provision of Statutory Audit Services. For the purposes of the Order, a Competitive Tender Process includes a tender process held at times when the Company was outside either or both the FTSE indices. The Order does not seek to be overly prescriptive as to the use of a particular tender process, however, for the avoidance of doubt, a tender process conducted in accordance with the Regulation would be deemed a Competitive Tender Process for the purposes of this Order.
- (e) **FTSE 350 Company** – means a company whose equity shares are admitted to trading on the London Stock Exchange and which is included in the FTSE 100 or 250 indices. As noted above, this is a shifting class, with membership changing from time to time.
- (f) **Statutory Audit** – means an audit conducted in accordance with the requirements of Part 16 of the Companies Act.
- (g) **Article 2.6** provides that the obligations delegated to the Audit Committee throughout the Order are without prejudice to the responsibilities and liabilities attaching to directors by law. This Order should be interpreted in accordance with the principle of the unitary board with all directors remaining equally responsible for the FTSE 350 Company’s affairs as a matter of law.

Part 3 – The prohibition

18. Article 3 provides that an Auditor and a FTSE 350 Company must not enter into or give effect to a Statutory Audit Services Agreement unless an Auditor Appointment has been made pursuant to a Competitive Tender Process in relation to one or more of the preceding nine consecutive Financial Years. The aim is to ensure that FTSE 350 Companies put their Statutory Audit Services engagement out to tender every ten years or earlier. This means that an Auditor may not conduct more than ten consecutive Statutory Audits of a FTSE 350 Company without a Competitive Tender Process having taken place. Further, the terms of the Statutory Audit Services Agreement must have been negotiated and agreed between the Audit Committee and the Auditor, and the provisions of Article 4 complied with.

Part 4 – Mandatory use of competitive tender processes – further provisions

19. Articles 4.1 to 4.3 detail the reporting obligations of Audit Committees in relation to the use of Competitive Tender Processes.
20. If a Competitive Tender Process has not been completed for Auditor Appointments in relation to five consecutive Financial Years, the Audit Committee must, in the Audit Committee Report covering the fifth Financial Year, state the Financial Year in which the FTSE 350 Company intends to complete a Competitive Tender Process and why this period is in the best interests of the members. This reporting process must also be repeated in each subsequent Audit Committee Report until the FTSE 350 Company completes a Competitive Tender Process. Where the Audit Committee decides that a proposed Financial Year is no longer the appropriate period in which to conduct a Competitive Tender Process, it must provide reasons for the decision.
21. Article 4.4 provides for information required to be provided to Bidders in a Competitive Tender Process and seeks to align requirements with the Regulation. Tender documents may, for example, include disclosure to Bidders of information on the planning and execution of, and findings of the Incumbent Auditor, in relation to the Statutory Audit of the Group, and a breakdown of the number of hours worked by staff grade, geographic location and principal audit areas.

Part 5 – Audit Committee responsibilities – further provisions

22. Article 5 details matters which are the functions solely of the Audit Committee and includes negotiating and agreeing the Statutory Audit fee, the initiation

and supervision of Competitive Tender Processes and making recommendations to the board of directors regarding Auditor Appointment.

23. The Audit Committee is also responsible for authorising the Incumbent Auditor to conduct Non-Audit Services prior to the commencement of those services. However, as this may place a disproportionate/unnecessary burden on the Audit Committee, it may set a policy for the pre-approval of Non-Audit Services including setting a threshold for low-value Non-Audit Service engagements.

Part 6 – Transitional provisions – mandatory use of competitive tender processes

24. Article 6 seeks to align transitional provisions regarding mandatory use of Competitive Tender Processes more closely with Article 41 of the Regulation in order to avoid potential conflicts for FTSE 350 Companies, and differs from the transitional provisions envisaged in the Report (which made use of Audit Engagement Partner rotation periods).
25. The Regulation came into force on 17 June 2014 and the application date of the Regulation is 17 June 2016 (Article 44). Article 41 of the Regulation provides as follows:

Transitional provisions

1. As from 17 June 2020, a PIE shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that PIE for 20 and more consecutive years at the date of entry into force of this Regulation.
2. As from 17 June 2023, a PIE shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that PIE for 11 and more but less than 20 consecutive years at the date of entry into force of this Regulation.
3. Without prejudice to paragraphs 1 and 2, the audit engagements that were entered into before 16 June 2014 but which are still in place as at 17 June 2016 may remain applicable until the end of the maximum duration referred to in the second subparagraph of Article 17(1) [ie 10 years] or in point (b) of Article 17(2) [ie less than 10 years]. Article 17(4) shall apply.

4. Article 16(3) shall only apply to audit engagements after the expiry of the period referred to in the second subparagraph of Article 17(1).
26. Articles 6.1(a) and (b) of the Order make use of the dates in Articles 41(1) and (2) of the Regulation by which the Regulation requires that certain PIEs switch Auditor. However, where an Auditor other than the Incumbent Auditor (as at 17 June 2014) is appointed on or after 17 June 2016, the provisions of Articles 3.1(a) and 4.4 of the Order apply in respect of that appointment and all subsequent Auditor Appointments (Article 6.2 of the Order).
27. Article 6.1(c) provides that where an Incumbent Auditor has held office in relation to less than 11 consecutive Financial Years as at 17 June 2014, the provisions of Articles 3.1(a) and 4.4 apply in respect of Auditor Appointments made on or after 17 June 2016. The timing of a Competitive Tender Process would then depend on when the FTSE 350 Company last put its audit engagement out to tender.
28. While Article 41(3) of the Regulation applies to PIEs that have retained the same Auditor for less than 11 years as at 17 June 2014 and which Auditor is still in place as at 17 June 2016, Article 6.1(c) of the Order covers FTSE 350 Companies that have retained the same Auditor for less than 11 years, irrespective of whether that Auditor is still in place as at 17 June 2016. We consider that this is appropriate because the application dates of the Regulation and the Order differ and so as to avoid a situation where FTSE 350 Companies that have retained an Auditor for less than 11 years as at 17 June 2014 but who shortly after the Order comes into force wish to switch Auditor, from potentially having to go out to tender immediately.
29. This is reinforced by Article 6.2 of the Order. Where a FTSE 350 Company switches Auditor between 17 June 2014 and 16 June 2016, the provisions of Articles 3.1(a) and 4.4 will not apply to that Auditor Appointment. However, where an Auditor other than the Incumbent Auditor (as at 17 June 2014) is appointed on or after 17 June 2016, the provisions of Articles 3.1(a) and 4.4 apply to that and all subsequent appointments.

Part 7 – Monitoring and compliance

30. Article 7.1 provides that FTSE 350 Companies must provide a statement of compliance with the Order in the Audit Committee Report for each Financial Year.
31. Article 7.2 provides that an Incumbent Auditor must provide to the CMA, within 15 working days of a request, certain information in relation to each of

the FTSE 350 Companies for which it is serving as Incumbent Auditor. This is so as to assist the CMA in monitoring compliance with and reviewing operation of the Order.

Part 8 – Directions by the CMA as to compliance

32. Article 8 provides that the CMA may give directions as to compliance with the Order.

Part 9 – Supply of information to the CMA

33. Article 9 provides for the supply of information to the CMA, by any person to whom this Order applies, for monitoring compliance with and operation of the Order.

How the use of tender processes provisions in the Order are expected to operate within the Regulation framework

34. The Regulation provides that neither the initial appointment nor any renewal of an audit engagement of a PIE shall exceed a maximum duration of ten years (Article 17(1)).
35. The effect of the Regulation is that PIEs must tender the audit engagement both before the initial appointment (Article 16) and also so as to take effect at the end of the maximum duration. Renewals of statutory auditor appointment within the maximum duration do not require a public tender process.
36. By way of derogation from the maximum duration of ten years, member states may set a maximum duration of less than ten years (Article 17(2)(b)).
37. By way of further derogation, member states may provide that the maximum duration of the audit engagement may be extended to up to 20 years,¹ provided that retendering takes place at least every ten years (Article 17(4)(a)).
38. We understand the UK Government is minded, subject to consultation, to take advantage of this derogation and that this is consistent with the Government's negotiating position during the negotiation of the EU audit reforms.
39. The provisions of the Regulation in combination with this Order will mean, in the base position where the maximum duration of an audit engagement is ten

¹ The Regulation also contains a derogation enabling member states to set a maximum duration of 24 years in relation to joint audit cases.

years, that a FTSE 350 Company must go out to tender in respect of the Auditor Appointment that is to take effect at the end of year ten (Regulation, Article 17(1) and this Order, Article 3.1(a)). The maximum duration of the audit engagement may then be extended by a further ten years, to up to 20 years (Regulation, Article 17(4)(a)). At this point, the FTSE 350 Company must switch Auditor, pursuant to a tender (Regulation 17(4)(a)).

40. As mentioned above, it is open to member states to set a lesser maximum duration than ten years. On exercise of this derogation, the maximum duration of an audit engagement may therefore be less than ten years for a FTSE 350 Company (Regulation, Article 17(2)(b) and this Order, Article 3.1(a)). The audit engagement may then be extended along similar lines to those outlined in paragraph 39 above.