



Governance *in brief*

The Competition & Markets Authority's final Order on mandatory tendering and audit committee responsibilities for FTSE 350 companies

Headlines

- Mandatory tendering every ten years for FTSE 350 companies in line with the EU Regulation.
- Transitional arrangements confirmed in line with those in the EU Regulation.
- Increased responsibilities for audit committee supervision of the external audit relationship largely put existing best practice on a statutory basis, but will see audit committees more engaged in the detail.

Introduction

Earlier this year, the Competition & Markets Authority (CMA, formerly the Competition Commission) formally consulted on a draft Order setting out how the remedies arising from its investigation of statutory audit services for large companies could work effectively with the new EU Regulation 547/2014 on the statutory audit of public interest entities so as to provide certainty as to the timing of tenders.

The CMA Order introduces wide ranging responsibilities for the Audit Committee Chair.

Mandatory tendering

Under the final Order a FTSE 350 company is prohibited from appointing an auditor unless there has been a competitive tender process in relation to one or more of the preceding nine financial years or in relation to the next financial year. A competitive tender process is a process where a company invites and evaluates bids for the provision of statutory audit services from **two or more** auditors.

Where a FTSE 350 company has not completed a competitive tender process for five consecutive financial years, the audit committee must set out in the audit committee report for each year until a competitive tender process is undertaken:

- 1) the financial year in which the FTSE 350 company plans to complete a competitive tender process; and
- 2) the reasons as to why completing a competitive tender process in that financial year is in the best interests of the company's members.

It is expected that the BIS consultation on the implementation of the EU directive will take the Member State option to require all public interest entities to tender every ten years and mandate auditor rotation after twenty years – so the supplementary effect of this part of the final Order is to encourage FTSE 350 companies to consider tendering every five years with an explanation if the company does not believe this is in the shareholders' interests.

Deloitte comment

Whilst the CMA Order requires at least two firms to be invited to tender, the EU Regulation requires two firms to be put forward by the audit committee for nomination, with a clear preference expressed for one. In practice, this would mean more than two firms being invited to tender.

Transitional arrangements

The transitional arrangements, which have been designed to align with the EU Regulation, are as follows:

- (a) where an incumbent auditor of a FTSE 350 company has been appointed as auditor for 20 or more consecutive financial years as at 17 June 2014, there must be a competitive tender process in respect of auditor appointments (at the AGM) made on or after 17 June 2020;
- (b) where an incumbent auditor of a FTSE 350 company has been appointed as auditor for between 11 and 19 consecutive financial years (inclusive) as at 17 June 2014, there must be a competitive tender process in respect of auditor appointments (at the AGM) made on or after 17 June 2023; or
- (c) where an incumbent auditor of a FTSE 350 company has been appointed as auditor for fewer than 11 consecutive financial years as at 17 June 2014, there must be a competitive tender process in respect of auditor appointments (at the AGM) once the auditor has completed ten audits on or after 17 June 2016.

The slightly counter-intuitive effect of (c) is that FTSE 350 companies whose auditors have been in place for up to 10 years as at 17 June 2014 may be required to tender earlier than those whose auditors have been in place for 11 years or more.

Further audit committee responsibilities

Under the final Order, only the audit committee, acting collectively or through its chairman, and for and on behalf of the board of directors, is permitted:

- to negotiate and agree the statutory audit fee and the scope of the statutory audit;
- to initiate and supervise a competitive tender process;
- to make recommendations to the board of directors as to the auditor appointment pursuant to the competitive tender process;
- to influence the appointment of the audit engagement partner; and
- to authorise an auditor to provide any non-audit services to the FTSE 350 company or the group of which that FTSE 350 company is a part, prior to the commencement of those non-audit services.

The audit committee may specify a policy for permitted non-audit services including setting materiality thresholds based on the value of the proposed non-audit service engagements.

The EU regulation will require audit committees to propose two potential auditors to the board indicating a clear, reasoned preference for one. Whilst, in theory, a tender in which only two firms participate could meet this requirement, in practice companies will likely wish to invite more candidates.

Deloitte comment

This provision comes into force for financial years commencing on or after 1 January 2015. Audit Committees may wish to use some of the time at their next meeting to consider whether any changes need to be made to their terms of reference to align with the CMA Order (which has the force of law); they may also wish to anticipate the changes in EU law regarding audit committee responsibilities to avoid successive changes in successive years.

Monitoring and compliance

A FTSE 350 company must include a statement of compliance with the provisions of this Order in the audit committee report for each financial year.

Commencement and scope of the Order

This Order will come into force on 1 January 2015 and apply to financial years beginning on or after 1 January 2015. This means that the audit committee's terms of reference will need to be revised for 2015. The tendering changes are subject to transitional provisions as set out above.

The provisions of the Order apply to a company from the date on which it enters the FTSE 100 or FTSE 250 index until the date on which it ceases to be a FTSE 350 Company.

Interaction with UK Corporate Governance Code provision on tendering

For the time being the UK Corporate Governance Code provision on tendering every ten years will remain and FTSE 350 companies will be required to 'comply or explain'. The FRC has indicated that the removal of the tendering provision will be considered as part of its 2016 review of the Code.

Under the FRC's own transitional arrangements, this means that where the auditor has been in place since before 2000 and the existing audit partner changes, either a tender will be required or an explanation must be given. This contrasts with the requirements of the CMA Order and EU Regulation, which have the force of law.

Ban on contractual clauses restricting the choice of auditor

The CMA had proposed a second Order to prohibit contractual restrictions on the choice of auditor – so-called "Big 4 only clauses". As such clauses will be banned by EU law from 17 June 2017, they have decided that this order is unnecessary.

Next steps on UK implementation of the EU Regulations

We are expecting a consultation from the Department for Business, Innovation and Skills on implementation of the EU audit reform regulations (including the mandatory rotation requirements) by the end of this year. BIS has indicated that, subject to consultation, they intend to adopt all of the flexibilities in the EU framework.

To read the final Order

The final Order can be found at: <https://www.gov.uk/cma-cases/statutory-audit-services-market-investigation>

Deloitte view

- The audit market has changed significantly since the inception of the Competition Commission investigation, in particular with the EU imposed requirement for mandatory tendering and rotation across the listed sector and certain regulated entities. Many companies are already tendering in advance of any EU, CMA or FRC requirement.
- The CMA's alignment with the EU Regulation is to be applauded as a practical answer that also achieves the CMA's objectives.
- The codification of activities reserved for the audit committee will lead to more engagement by audit committees in the detail of the scope and risks of the audit and will encourage greater provision of detailed information on planning and scoping by audit firms.
- There is a clear expectation in both EU law and by the FRC that audit committees should consider audit quality as part of any tender. In advance of any FRC guidance in this area, we suggest using some of the questions in our *Governance in focus – Effectiveness of the external audit process* as a tool to help.
- Whilst "Big 4 only" clauses are, in our experience, virtually unheard of in listed company loan agreements, we suggest audit committees make clear that they think they are inappropriate in any new loan agreement, regardless of the fact the EU ban does not come into force until 2017.

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