CMA Order for UK audit market

On 26 September 2014 the Competition and Markets Authority (CMA) published its Order for the UK audit market. The Order\(^1\) gives effect to various changes required of UK incorporated FTSE 350 audit committees under the ambit of the Enterprise and Regulatory Reform Act 2013. Section 167 of the Act places a duty on any person to whom the Order applies to comply with it. Any person who suffers loss or damage due to a breach of this duty may bring legal action against the company concerned, and the CMA can seek to enforce the Order by civil proceedings.

The Order applies with immediate effect to financial years beginning on or after 1 January 2015. One exception is made for mandatory audit firm tendering, which is subject to transitional arrangements aligned with the European Union’s transition rules for mandatory audit firm rotation.

Introduction

The Order is the culmination of a three and a half year inquiry triggered in March 2011 by the House of Lords Select Committee on Economic Affairs. The Committee requested that the Office of Fair Trading (OFT) consider whether the level of concentration in the UK audit market should be investigated. The OFT took the view that it should, and referred the matter to the Competition Commission (CC) later the same year. In October 2013, after extensive inquiries and public consultations, the CC published its “remedies” which form the basis of today’s Order.

\(^1\) The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014
Laura Carstensen, who chaired the inquiry, said:

“It’s vital that shareholders have confidence that auditors are providing an independent and sceptical assessment of a company’s accounts. More regular switching not only opens up the market to greater competition but also reduces the long tenures that can reduce the appearance of objectivity.”

**Key requirements of the Order**

The following information highlights selected requirements of the Order which we consider particularly noteworthy. It is intended to provide general information for the purpose of discussion and should not be taken as advice. We encourage companies to read the Order in full and if necessary seek independent legal advice.

**Mandatory tendering**

The CMA’s aim for introducing mandatory audit firm tendering is to ensure UK incorporated FTSE 350 companies put their statutory audit out to tender at least once every ten years (Article 3.1(a)). The tender itself should follow a competitive process as outlined in the Order.

**Transition to mandatory tendering**

The Order aligns transition to mandatory tendering (Article 6) with the EU’s transitional rules for mandatory audit firm rotation. The EU’s rules came into force on 16 June 2014 and take effect from 17 June 2016.

**Transitional provisions**

The following examples refer to a FTSE 350 company incorporated in the UK with a 31 December year end.

- If the incumbent auditor (as at 16 June 2014) was appointed before 16 June 1994 the company is required to switch auditor for 2021 (EU requirement) by inviting and evaluating bids from two or more firms using a competitive tender process (CMA and EU requirement).

- If the incumbent auditor (as at 16 June 2014) was appointed between 16 June 1994 to 16 June 2003, the audit has to be switched for 2024 (EU requirement) by inviting and evaluating bids from two or more firms using a competitive tender process (CMA and EU requirement).

- If the incumbent auditor (as at 16 June 2014) was appointed at any time between 2003 and 16 June 2007, the company will be required to tender their auditor for the first financial year beginning on or after 17 June
2016 (EU requirement and CMA Order requirement). However, note that under EU rules the company may be required to rotate their auditor at this point (EU requirement) unless the UK adopts 20 year tenures and legislates accordingly before 17 June 2016 (EU derogation).

- If the incumbent auditor (as at 16 June 2014) was appointed on or after 17 July 2007, the company will be required to tender their auditor when its auditor has been appointed for 10 consecutive financial years. For example, if the auditor was first appointed for financial year 2009, the company will be required to tender their auditor for financial year 2019. However, note that under EU rules the company may be required to rotate their auditor at this point (EU requirement) unless the UK adopts 20 year tenures (EU derogation).

**Mandatory use of a competitive tender process**

If a competitive tender process to appoint an auditor has not been completed for five consecutive financial years, the audit committee (“committee”) must state in year five when it intends to conduct such a tender (Article 4). This must be disclosed in the committee’s report (or elsewhere in the annual report) with an explanation as to why that period is in the best interests of shareholders. The disclosure should be repeated every subsequent year until the year of tender, or an explanation provided if that date is no longer appropriate.

The Order is unclear as to when the five-year clock starts, but in line with the spirit of the Order it would be prudent for audit committees to make the first of such disclosures from 1 January 2015, if they have not tendered in the previous five years.

**Information to be provided to bidders**

Committees should provide bidders with information that allows them to understand the company’s business and type of statutory audit to be conducted. Examples include the planning, execution and findings of the incumbent auditor, and details on the time, resource and scope of that audit.

**Specific responsibilities of the audit committee**

The Order outlines various activities for which the committee is responsible, (Article 5). These include the following: i) negotiating and agreeing the statutory audit fee; ii) initiation and supervision of a competitive tender process; iii) influencing the appointment of the audit engagement partner; iv) making recommendations to the board on the auditor appointment; v) authorisation of non-audit services (“NAS”); and the option of setting a policy for the pre-approval of NAS, including thresholds for permitting low-value NAS.
Monitoring and compliance

UK incorporated FTSE 350 companies must provide a statement of compliance with the Order in the committee report (or elsewhere in the annual report) for each financial year (Article 7.1). In addition, the CMA may request information from an auditor in relation to each of its FTSE 350 audit clients. This has to be provided within 15 working days of the request being made (Article 7.2).

Our viewpoint

The health of the UK’s audit market can be judged, in part, by the various remedies which were proposed, evaluated but never progressed by the competition authorities. For example, the CMA’s forerunner recognised that introducing joint audits and adding further restrictions on non-audit services was neither in the public interest, or necessary or material to competition in the audit market.

Decisions made by the CC also indicated that competition between audit firms is healthy and robust, and that retaining auditors on tender is not a competition problem. Indeed, it was noted that for the most part audits are done extremely well and meet the needs of shareholders and other company stakeholders.

Questions companies should ask themselves

- Does the audit committee (“committee”) have a clear policy for the pre-approval of non-audit services (“NAS”)? If it does, when was the last time it reviewed its fee thresholds?
- If the committee does not pre-approve the use of NAS, has it considered the merits of developing a policy for that purpose? It will help to save time and enable the use of a NAS required at short notice. It will also help the board to prepare for the application of the EU’s new audit regulations.
- Does the board understand the wider implications of the new EU audit regulations, in terms of the company’s future procurement of professional services, and the obligations it will have to meet in the UK when appointing the statutory auditor?

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Want to know more?
If you have any questions, please speak with your usual EY contact or get in touch with one of us:

**Hywel Ball**  
Managing Partner Assurance, UK and Ireland & UK Head of Audit  
Tel: +44 131 777 2318  
Email: hball@uk.ey.com

**Andrew Walton**  
Head of Markets Assurance  
Tel: +44 20 7951 4663  
Email: awalton@uk.ey.com

**Andrew Hobbs**  
Associate Partner, Corporate Governance & Public Policy  
Tel: +44 20 7951 5485  
Email: ahobbs@uk.ey.com