

A stylized, high-contrast image of the London skyline, including the Tower Bridge and the Gherkin, with a red arch over the scene.

Audit Review: **requirements of the revised Code and Guidance on Audit Committees**

Audit Review: **TECHNICAL NOTE**

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David trained as a Chartered Accountant at the London office of Arthur Andersen (now Deloitte). Following a spell in investment banking, he became finance director of a London Stock Exchange premium-listed company. In this latter role he was a major user of the audit services and non-audit services of a "Big 4" firm as well as having oversight of internal audit. He combines his role at Audit Review with a number of non-executive directorships and is chairman of the audit committees of two sizeable insurance companies.

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Audit tendering: the requirements of the revised Code and Guidance on Audit Committees

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Introduction

In September 2012, the Financial Reporting Council (“FRC”) published revisions to the UK Corporate Governance Code (“the Code”) and revised Guidance on Audit Committees (“the Guidance”). The Guidance is designed to assist company boards in making suitable arrangements for their audit committees, and to assist directors serving on audit committees in carrying out their role. While boards are not required to follow this guidance, it is intended to assist them when implementing the relevant provisions of the Code.

Included in the revised Code is a new requirement which broadly requires listed companies in the FTSE350 to tender their external audits every 10 years or explain why they have not done so. The new requirements were subject to extensive consultation in 2011 and 2012.

The FRC has announced that it will be holding discussions with audit committee chairs, finance directors, audit partners and investors to consider whether further guidance on tendering would be useful.

When does the new guidance apply?

The new Code provisions apply to reporting periods beginning on or after 1 October 2012, subject to the transitional provisions on the timing of audit tenders, which are covered below.

Detailed new Code provisions

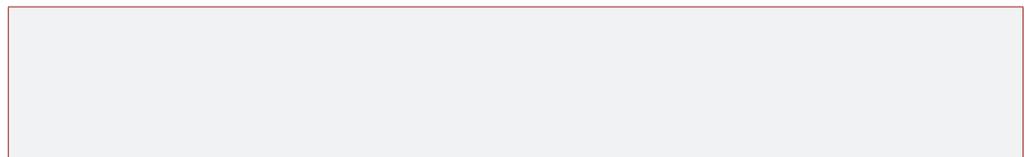
Code provision C.3.7 has been supplemented with the provision that: “FTSE 350 companies should put the external audit contract out to tender at least every 10 years”.

The FRC has made it clear in the Feedback Statement to the changes that it does not consider a “comply or explain” requirement for regular tendering to be mandatory rotation by another name. The FRC considers it is very important that the decision on which auditor to appoint and when to change auditor remains with the company and its shareholders. The purpose of holding a tender is for companies to benchmark the services provided by the incumbent auditor against those offered by other firms, with the aim of obtaining the best quality and most effective audit. If the company judges that this is best secured by reappointing the incumbent auditor, then that is what it should do.

Code provision C.3.8 which requires the annual report to explain how auditor objectivity is safeguarded has been replaced by a requirement (already required in the FSA’s Disclosure and Transparency Rules) for a separate section of the annual report to describe the work of the audit committee. The Code now requires that the section contains:

- the significant issues that it considered in relation to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted;
- and, if the auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.

Audit Review comment: the disclosure of the length of tenure and when the audit was last tendered was previously include in the Guidance, but is now subject to the full force of the Code’s “comply or explain” requirement. As a result company reporting should now become more detailed and consistent.



Details of the new Guidance

The following new points have been added to the Guidance on the external audit process:

4.21 If the audit committee recommends considering the selection of possible new appointees as external auditors, it should oversee the selection process, and ensure that all tendering firms have such access as is necessary to information and individuals during the duration of the tendering process.

4.22 Audit committees may want to consider whether there might be any benefit in using firms from more than one audit network and guidance on the considerations relevant can be found on the FRC website¹.

Audit Review comment: whilst this was an existing provision, we believe this will take on more relevance as more audit tenders are conducted.

4.23 FTSE 350 companies should put the audit services contract out to tender at least once every ten years, to enable the audit committee to compare the quality and effectiveness of the services provided by the incumbent auditor with those of other audit firms. So that there is time to undertake an effective and open tender process and to allow shareholders to provide input into the process should they wish, the company should announce its intention in advance of the commencement of the tendering process.

4.25 On the need to consider the further constriction of the audit market (introduced following the collapse of Arthur Andersen), has been amended to say “The audit committee should evaluate the risks to the quality and effectiveness of the financial reporting process, and should consider the need to include the risk of the withdrawal of their auditor from the market in their annual evaluation.

4.26 On the content of the audit committee report as regards the external auditors, has been revised to say that the audit committee section of the annual report should include an explanation of how the committee has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, in order that shareholders can understand why it recommended either to reappoint or change the auditors. It should also include information on the length of tenure of the current audit firm, when a tender was last conducted and any contractual obligations that acted to restrict the audit committee’s choice of external auditors.

A number of other minor changes have been made to the order of paragraphs.

¹ <http://www.frc.org.uk/getattachment/3696dea1-46ba-420d-87e0-5d72d224f6cc/Guidance-on-the-use-of-audit-firms-from-more-than-one-network-September-2012.aspx>



Transitional arrangements

The FRC recognised that the introduction of regular tendering for the external audit contract, even on a “comply or explain” basis, would need to be carefully managed. If all those companies that have not gone out to tender in the last ten years were to do so in the first year following the change to the Code the market would struggle to cope.

Therefore, the Code requirements on audit tendering are only applicable to FTSE350 companies “in the first instance”. There is a clear implication that regular tendering should become best practice and the requirements may, in future, be extended to smaller companies subject to the Code.

The transitional arrangements are not intended to be binding arrangements and are therefore not incorporated either in the Code of the Guidance, but are set out on the FRC’s website². The FRC has made it clear that: “companies should put the audit contract out to tender earlier than they would be expected to under these arrangements if they feel it is appropriate to do so, and shareholders should feel free to request them to do so. Equally, as with all other provisions of the Code, companies can choose not to comply and explain why not. Whatever their decision, the FRC would encourage companies to state when they first report against the 2012 Code whether or not they anticipate putting the audit contract out to tender in due course.”

The suggested timing of a tender is linked to two criteria:

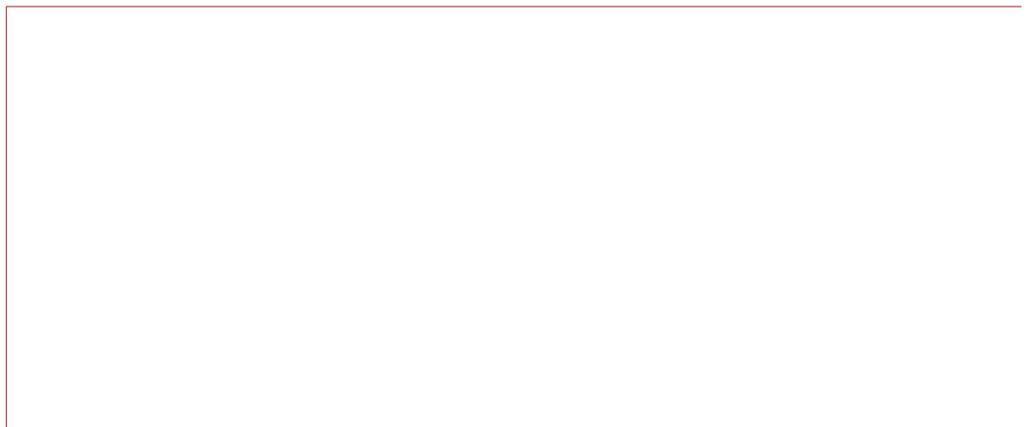
- when the current audit engagement partner is due to rotate; and
- the length of time since the audit contract was previously tendered.

It is suggested that where a company has put the audit contract out to tender or changed audit firm in or after 2000, the tender process might be deferred until the latter stages of the incoming audit engagement partner’s term. In other words, for a further five years.

Example:

Next partner rotation for accounting year ending	Year due to tender		Notes
	Have <u>not</u> tendered since 1999	Have tendered since 1999	
On or before 30th September 2013	2018	2018	Revisions applicable to accounting periods beginning after 1st October 2012
31st December 2013	2013	2018	
31st December 2014	2014	2019	

² <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>



Further Reading

UK Corporate Governance Code, September 2012 *Financial Reporting Council*

<http://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>

Guidance on Audit Committees, September 2012 *Financial Reporting Council*

<http://www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx>



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