



Financial Reporting Council

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Office of the Secretary
Public Company Accounting Oversight Board
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Washington
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United States of America

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Dear Sir,

PCAOB Rulemaking Docket Matter 37: Auditor Rotation

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate reporting and governance to foster investment. We welcome the opportunity to respond to the PCAOB's concept release on auditor rotation.

The UK audit market, in common with the US and with most other developed countries, sees relatively few auditor changes, especially at the top end of the market. Research by Oxera for the FRC estimated that the average tenure of an auditor of the 100 largest UK companies is 48 years. We have seen indications that audit tenders have become more frequent since the beginning of the financial crisis and it is increasingly seen as part of good governance. However, it is clear that historically it has been rare for the very largest companies to change auditor, or even to put their audits out to tender. We see four main risks arising from the relative infrequency of tendering:

- Despite requirements for engagement partner rotation, long standing audit firm tenures increase the risk of familiarity leading to a lack of challenge of the client.
- A loss of public confidence in audit as a result of a perception that auditors are too close to client management.
- There is a lack of competition in the audit market which can only be remedied if non-Big Four firms have the opportunity and experience to take on the audits of large listed companies.

- Firms are unlikely to improve the quality of their offering or seek to distinguish themselves on the grounds of quality if they know that the likelihood of them being replaced is remote.

We have seen little concrete evidence that auditor independence has been impaired as a result of lengthy auditor tenures and believe that mandatory partner rotation and the requirement to consider long service of other senior members of the engagement team generally address the familiarity threat. There remains, however, a perception that independence may be impaired by audit relationships which last several decades.

For the reasons set out above we support measures which increase the frequency of tendering, and force audit committees and company management to consider the effectiveness of their auditor. However, we have reservations about introducing mandatory auditor rotation for a number of reasons:

- It forces companies to change auditor regardless of the quality of that auditor's work. The overall effect on audit quality may be negative.
- Companies in certain sectors may have a very limited choice of auditor; in some industries there are only two or three firms which are judged to have the expertise, capability and global reach to conduct an effective audit.
- The very largest companies are likely to experience difficulties in changing auditor whilst still meeting independence requirements. Such companies will use other large audit firms for non-audit engagements, some of which may not be terminable at short notice. Due to concerns about confidentiality, many such companies are also reluctant to appoint a firm which audits a major competitor.
- In the case of multinationals, it may result in companies having different auditors in different jurisdictions, particularly if the PCAOB's final proposals are different to those recently proposed by the European Commission.
- In jurisdictions where mandatory rotation has been introduced there is no clear evidence of increased innovation or of a greater propensity to appoint non-Big Four auditors. There is a risk that mandatory rotation may in fact increase market concentration as Big Four firms focus on winning the audits of the small number of listed companies which currently employ a mid-tier firm.

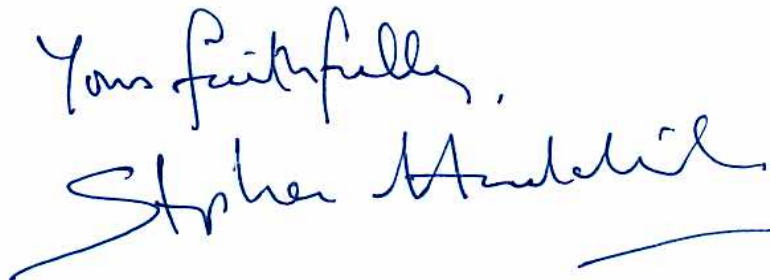
There are therefore clearly a number of significant challenges associated with mandatory rotation. If the PCAOB decides to proceed down this route, we would stress that it should not be done in a vacuum. If mandatory rotation is to enhance audit quality and/or reduce concentration in the market, its introduction would need to be accompanied by measures to mitigate the factors set out above, including:

- Flexibility in timing to allow companies to delay rotation in certain circumstances; for example, during a major corporate transaction or immediately following the sudden departure of a key member of the company's management team.

- Steps to prevent the market becoming even more concentrated, such as restrictions on the Big Four acquiring the audits of listed companies which are currently undertaken by non-Big Four firms.
- A relaxation of independence rules, at least for a transitional period, to allow sufficient firms, some of which may currently provide non-audit services to a listed company, to tender for its audit.

As an alternative to mandatory rotation, our preference is for a requirement for listed companies to put their audit out to tender every ten years, or to explain why they have chosen not to do so. This will in our view address concerns about the length of the audit relationship without forcing companies to go elsewhere without reason. We set out our thinking on this in greater detail in our paper *Effective Company Stewardship: Next Steps* which was published earlier this year, and we will shortly issue detailed proposals for changing the UK Corporate Governance Code to reflect this new requirement.

If you have any queries please contact Paul George, Director of Auditing, on 020 7492 2340 or p.george@frc-pob.org.uk.

Yours faithfully,


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