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Department for Business, Energy and Industrial Strategy
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PLSA Response: Department for Business, Energy & Industrial Strategy – initial consultation on the Competition and Markets Authority’s recommendations

About the PLSA

The PLSA is the voice for pensions and lifetime savings in the UK, representing over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses – including asset managers, investment consultants and other service providers. Our purpose is to help everyone achieve a better income in retirement.

Introduction

The PLSA welcomes the opportunity to respond to the Department for Business, Energy & Industrial Strategy (BEIS)’s consultation on the Competition and Markets Authority (CMA)’s recommendations from its market study on statutory audit services. The PLSA has an interest in ensuring that the audit market services the need of our pension fund members as investors in UK companies through equity and corporate bond holdings. Financial statements which have been subject to a high-quality audit are vital to investors in making decisions.

Defined Benefit (DB) pension schemes have an interest in a well-functioning statutory audit market. It is important that schemes are able to gain an accurate understanding of the health of their employer covenant as this feeds through to the levels of Deficit Repair Contributions (DRCs) and ultimately a scheme’s funding level and ability to meet its commitments. Being able to rely that the financial statements of the sponsoring employer represent a true and fair picture of the company’s financial health is particularly important for those schemes which have a weak sponsor or face a funding shortfall – and there are many such DB schemes in the UK at present.

Our response builds on engagement with schemes both as investors and as DB trustees, as well as on our previous responses to the Kingman Review of the Financial Reporting Council (FRC) and our views on the CMA’s initial Invitation to Comment. We do not respond to each and every question and instead have highlighted some of the key issues below.

The audit committee: regulatory oversight

We have welcomed previous work to strengthen the oversight, governance and transparency of audit committees. The PLSA’s own *Corporate Governance Policy and Voting Guidelines*, which are updated annually, have long encouraged investors to carefully scrutinise the decisions, quality and

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approach of investee companies' audit committees and to consider how they exercise their voting rights accordingly.

We believe that the quality of audit committees and their effectiveness at fulfilling an important role has tended to be neglected by regulators in favour of other issues. We agree with the FRC in its identification of best practices and recommendations but we would hope to see the new regulator exercise greater scrutiny of audit committees' role and effectiveness. Setting standards for audit committees when an audit tender is undertaken would be a welcome step and would, we hope, be accompanied by a tougher and more demanding approach from the new regulator.

We think that further clarity is needed from the new regulator regarding its role in monitoring how and whether audit committees have met these new standards.

More generally, we hope that ARGA will be more proactive in responding to concerns and intelligence from the broad range of market participants than its predecessor. A particular concern raised by our members was the lack of transparency around the FRC's investigative processes and procedures, including its Audit Quality Reviews (AQRs). Better information disclosure and guidance regarding what is considered poor and good practice, including publishing the outcome of individual firms' AQRs would be helpful to both audit firms and investors. This could also help engender greater confidence in the system as a whole.

The audit committee: shareholder information

Investors need more and better quality information from audit committees to better hold these committees to account, particularly around issues of the audit tender and the audit process (including fee breakdowns and audit staff hours).

On tendering, such information could include: reporting on whether any firms outside of the Big Four have been invited to tender for an audit contract and, if this is not the case, the reasons for this decision; the measures taken to mitigate and manage any potential conflicts between members of the audit committee and candidate firms; and details regarding how the winning firm was chosen as well as the criteria used for assessment.

Useful information for investors on the audit process could include: whether the audit committee believes that the auditor has provided a high-quality audit and the criteria used for assessment; areas where the committee itself challenged the auditors; and greater disclosure of fee breakdowns and audit staff hours – one of our members' concerns which has been reinforced by various investigations into audit failures is that audit teams may not be appropriately staffed and may not be given sufficient time to deliver effective audits.

Investor engagement on audit issues

Although we welcomed recent steps by the FRC to engage more fully with the investor community, we hope that the new regulator will undertake as a matter of urgency a wide and well-resourced programme of engagement with investors and other stakeholders. We believe that this will be vital in boosting investor confidence in the audit market and its regulation and reassure them that their views are being listened to, which should in turn encourage investors to engage on audit issues more generally.

We have previously expressed concerns about the relative imbalance of backgrounds of the FRC's staff, with what seems to be a significant and dominant proportion drawn from the accountancy and audit professions, as opposed to those with investor practitioner expertise and experience. Having greater representation of the investor perspective at every level of the new regulator and in every team could also help boost the two-way engagement process between investors and the regulator.

Joint audits

We agree that the additional scrutiny and challenge that could come from 'another set of eyes' could be helpful. However, we believe that this is a complex proposal to pursue including how to square the lack of consistency and approach, how smaller companies would deal with increased costs and challenges in ensuring clear accountability. There is also a question around how key players would respond and whether smaller firms would want to take on the risks of auditing international, complex and larger companies.

We agreed that a shared audit approach would risk cementing junior status for one firm and would not necessarily lead to the kind of improved market competition that the regulator is keen to see.

Market share caps

Some of our members believe that market share caps might more directly address the competition issues currently present in the audit market. However, there would also be many practical challenges to address in pursuing this remedy – for instance, an approach would need to be developed which would ensure that the biggest audit companies do not simply pick the less risky audit. Careful design and monitoring of a market share cap approach would also be required to minimise the risk of unintended and harmful market distortions.

Audit vs. non-audit functions

One of the key factors affecting the quality of an audit is how willing the auditor is to challenge and question management on their decisions and approach. Such professional scepticism is vital. We believe that the CMA has correctly identified the tensions which can arise at a firm which provides both audit and non-audit services.

Operational vs. structural separation

Although we believe that there are challenges to implementing an *operational* split and that it would require purposeful and well-articulated regulatory oversight to avoid unintended consequences, we would support such a split over a *structural* approach.

If firms were only allowed to provide audit services, it could impact their ability to retain the high-quality staff which are vital for an expert, meaningful and thorough audit; owing to the seasonality of most firms' audits, audit staff are often deployed elsewhere in a Big Four firm during 'off peak' times of the year. Likewise, often non-audit staff are needed to advise on the more complex and demanding audits.

On the overall market impact of an *operational* split, we note that a number of the firms most affected by the CMA remedies have already signalled steps towards such splits. We therefore believe that the challenges around pursuing this method may therefore be less than some of the media commentary would imply.

Tendering and rotation periods

We welcomed the measures under the 2014 European Directive and Regulation on Audit¹ for mandatory tendering and rotation. We believe that holding office for long periods can have a damaging impact on the quality of the audit as it affects firms' ability to be independent and objective, and their willingness to challenge management.

We believe that there is some evidence that a move to 10 and 20 year periods for tendering and rotation seem to be changing behaviour for the better. We would caution against any further upheaval in this respect until further evidence is gathered on the new regime – which was only introduced in 2016 in the UK – and its impact. Instead the focus should be on what can be done to help challenger firms in the market scale up until they are in a position to challenge the Big Four in competing for contracts to audit large and complex firms.

We hope that the above is helpful. If you would like any further information or have any questions, I hope that you will not hesitate to get in touch.

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¹ Directive 2014/56/EU and Regulation No. 537/2014