

Introduction

The National Association of Pension Funds (NAPF) is the UK's leading voice for workplace pensions. Our members have combined assets of around £900 billion, and operate some 1,300 pension schemes. NAPF membership also includes over 400 providers of essential advice and services to the pensions sector; these include accounting firms, solicitors, fund managers, consultants and actuaries.

We have an interest in ensuring the audit market serves the needs of our pension fund members. We believe the role of the auditor is of vital importance to investors in making assessments and investment decisions and the present level of audit quality and accompanying reporting could and should be enhanced.

The audit should provide a thorough and independent assessment, applied with a degree of scepticism, of the current position of the company, the risks it faces, and how those risks are being managed. We support measures to strengthen independence and improve competition in the audit market and believe it is vital to continue to strengthen the role of the audit committee and its relationship with and oversight of the auditor - this has the potential to significantly enhance audit quality and related financial reporting.

In November 2011, the European Commission set out proposals for reform of the audit market. Whilst the NAPF supports the Commission's goals, we believe the proposals should be modified in a number of areas. We set out our key positions below.

Audit Committees

In the UK, there is a greater emphasis placed on the role of the audit committee than is typical of some other EU member states. We believe further consideration should be given to the role of the audit committee and how it can more actively influence audit quality and consistency of audits across EU member states.

The onus should be on the audit committee to ensure that relevant and meaningful information is provided in both the annual accounts and the accompanying narrative report. Greater transparency in this area would provide increased reassurance to investors that appropriate frank discussions are taking place and due consideration has been given to the performance of the auditor and quality of the audit.

As the directly elected representatives of the shareholders, the audit committee ought to be in a position to more frankly disclose through its reporting the key matters discussed with the auditor and how they have been resolved.

At the same time care must be taken to ensure that rules relating to board compositions are not overly onerous and do not lead to difficulties for companies due to a shortage of suitable candidates.

Auditor reporting

Investors are keen to receive greater insight into aspects of the audit and audit committees and auditors both have a role in providing this.

We would like to see a fuller audit report which includes more pertinent information and commentary. At present the auditor opinion and the results of the audit provide only basic comfort to shareholders. The audit report should provide assurance that the information presented by the company is balanced and free from material misstatements; with greater transparency around audit methodology – including the key risks identified, level of coverage and the key areas of focus.

Greater disclosure would better ensure investors are informed as to audit processes, aiding them to distinguish between the quality and capability of audit firms.

We caution against excessive prescription as increased boilerplate reporting would not deliver the necessary added value.

Auditor Independence

Healthy competition in the audit sector is also important to audit quality as such the fact that the 'Big Four' dominate the audits of the vast majority of companies in the FTSE 350 is a concern. The current lack of choice may impact audit quality and we support measures to address the risks arising from excessive concentration in an effort to ensure auditor independence.

We further believe the current configuration of the audit market and the prevalence of the Big Four firms presents a systemic risk. The collapse of a 'systemic firm' could lead to disruption of the whole market and believe that steps should be taken to create a more secure audit market.

The UK is already undertaking an inquiry into competition in the large audit market. Similar investigations may be appropriate in other member states.

Mandatory rotation and re-tendering

We are conscious that in the UK, audit firms retain a FTSE-100 client on average for 48 years, and it is not uncommon for this to rise above 100 years with some clients. We believe that this is not a satisfactory situation and measures are evidently needed to increase the rate of rotation.

We believe that long periods of auditor incumbency can impact their independence and objectivity. A 'fresh pair of eyes' is beneficial and conducive to ensuring appropriate professional scepticism. Excessively long tenures can result in auditors becoming 'captured' by their own historical judgments and we are not convinced that partner rotation is always sufficient to mitigate this.

Our members are therefore sympathetic to proposals to increase auditor rotation, although believe the Commission proposal for mandatory rotation every six years is inappropriate.

We believe that Audit Committees should have a policy which sets out their approach to audit services, including in relation to re-tendering; maximum auditor tenure; any contractual obligations; shared audits and non-audit services. This policy should be disclosed to shareholders in order to ensure that they can deliver effective oversight and accountability.

In addition, there is strong support amongst most, but not all, of our membership that audit committees should be required to re-tender their audit services at least every 5-7 years with mandatory rotation after no more than 15 years. The tender should involve at least two candidates (other than the incumbent) to ensure genuine competition and to open the market to new entrants. We do not feel that there is a need to also require a smaller auditor be involved in the process. The selection and appointment process should be transparently set out for shareholders.

Such a move to require periodic re-tendering of audit services in combination with a maximum limit for auditor tenure could help improve competition within the audit market and potentially drive better value for shareholders.

We are strongly supportive of the annual shareholder vote on the appointment or re-election of the auditor and it is important that this right is retained.

Joint and Shared Audit

On the matter of joint audits, we have concerns that these could adversely impact audit quality and accountability and in addition lead to the smaller firms always becoming the junior party and consigned to this role in future.

We would however, encourage firms to set out within an audit policy their approach to shared audits. Such a disclosure could aid competition in the audit market by highlighting a firm's approach to building relationships with non Big Four audit firms.

Non-audit services

Non-audit work introduces a potential conflict of interest within the audit firm, especially where the non-audit work is more profitable than audit work.

We are concerned about the tendency of companies to use their auditors for non-audit work. While this can on occasion be justified on grounds of cost and relevant expertise, we believe that more use should be made of third parties, including smaller firms. We are not however, supportive of a total ban on the provision of non-audit services by audit firms; instead we believe this is a matter which should be carefully monitored by companies and shareholders alike. Our current NAPF Corporate Governance Policy and Voting Guidelines proposes a non-audit fee cap of 100% of audit, absent an explanation of any exceptional circumstances which may apply – we may also consider restricting this cap further.

In addition, if non-audit fees comprise more than 20% of the audit fees disclosed in the annual report, shareholders should be provided an analysis of the principal areas of non-audit fees and if appropriate utilise already available sanctions. We would also support a restriction on the provision of certain non-audit work, such as in relation to M&A activity. A company's clearly defined policy on non-audit work should form part of the audit committee's report to shareholders.

Pure audit firms

We do not support the prohibition of significant audit firms only focusing on statutory audits and not being allowed to undertake other services. By ensuring that on a client-by-client basis non-audit work is controlled as we suggest above, audit firms can be seen to give priority to their public interest work.

Audit should be the key service and when the fees for non-audit services reach a significant level, independence and objectivity can be compromised. We would welcome a common EU standard.

EU-wide adoption of ISAs

In principle the introduction of ISAs in the EU may be beneficial as this would facilitate consistency in audit processes. However, we would be hesitant about this approach given the already existing concerns with compliance focused audits and their ability to impact the unencumbered "true and fair view".

Other

These reforms present an opportunity to review the audit to ensure that it remains relevant and valued in the future. We encourage firms to consider the information they report – including non-financial information - and whether investors would benefit from additional independent assurance.

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For further information or to discuss the issues further please do not hesitate to get in touch - Will Pomroy, policy lead: corporate governance – will.pomroy@napf.co.uk / +44 (0) 20 7601 1719.