

## UK COMPETITION COMMISSION STATUTORY AUDIT SERVICES MARKET INVESTIGATION

### NAPF RESPONSE

#### 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.

We welcome the provisional findings of the UK Competition Commission's (UKCC's) inquiry into the statutory audit services market along with the Commission's proposed remedies. This analysis of the market comes at an important time in deliberations on proposed reforms to the EU Audit Market and we hope will give the process in Europe renewed impetus and direction.

As set out in the UKCC's provisional findings, audits are intended to provide assurance to shareholders that the financial reports prepared by the directors give a "true and fair" view of the financial state of the company. As such the report importantly recognises that it is the shareholders who are the "primary customer" of the audit; however, this is not reflected in current practices. Instead, auditors are often seen as insufficiently independent from executive management and insufficiently sceptical in carrying out audits; this is as the report identifies because the current system incentivises auditors to satisfy management rather than shareholders. This current situation can impact upon auditor independence, professional scepticism, innovation and ultimately audit quality.

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. We agree that no one solution will achieve this market correction, but rather what is needed is the combination of a package of measures which:

- Increases transparency to shareholders from both the audit firm and audit committee;
- Enables and promotes increased and improved shareholder engagement with the audit process; and
- Corrects the currently identified misaligned incentives through increased tendering and a legislative tenure back stop.

If such a package is introduced we are hopeful that the environment will evolve towards one where there is a clearer line of transparency and accountability between "client" and "customer" with more trusting and constructive relationships and increased truer competition in the audit market.

## Provisional findings

We recognise and agree with the analysis of the market as set out within the UKCC's provisional findings report.

We are conscious that in the UK, audit firms commonly retain a FTSE-100 client for many decades; the UKCC's own analysis found that 31% of FTSE100 companies have had the same auditor for more than 20 years and 67% for more than ten years; we believe that this is not a satisfactory situation.

The NAPF has for some time been a strong supporter of the concept of investor stewardship. However, in order for our members to act as stewards of the companies in which they have invested, they need sufficient information from which to be able to make appropriate assessments and judgements and on which to base engagements with those appointed to act on their behalf – the Directors of the company. As the UKCC identifies, shareholders have been seeking the provision of more information regarding the audit and audit process than is currently being provided within the audit report and the audit committee's report. Much work is currently underway around this issue via the IAASB, the FRC and others, and we trust the analysis provided by the UKCC will reinforce this process.

We agree that, as identified by the UKCC, shareholders at present, despite their legal rights, currently play very little role in any decision to appoint an auditor, in contrast to executive management. We would add however, that we do sense there is a growing appetite from many investors to engage more than has previously been the case on this important issue. Likewise we believe that many audit committees are reclaiming ownership of the audit firm relationship from executive management. That said, the misaligned incentives between shareholders and company management remain and we therefore support the introduction of remedies to safeguard the independence of the audit firm from management and thus safeguard the quality of the audit for shareholders.

## Proposed remedies

1. *Mandatory tendering; and*
2. *Mandatory rotation of audit firm*

We believe that where auditors hold office for long periods this can materially impact their independence and objectivity which are vital in ensuring audit quality. There is the risk of a reduced willingness to challenge management, especially where audit firms foster other non-audit relationships with their audit clients. We are therefore of the opinion that the current situation where audit firms often retain a client for a number of decades is not satisfactory and measures are evidently needed to increase the rate of rotation and maintain independence.

Reduction in average tenure thus represents a well-founded public policy objective and one that audit committees on behalf of shareholders should seek to achieve. Most other commercial relationships are subject to regular tendering and we suggest that the audit service should not be sheltered from this normal business approach.

We have welcomed the recent introduction by the FRC into the Corporate Governance Code of a requirement, on a comply-or-explain basis, to tender the audit service at least every ten years – this was a very positive

development. However, we have also been calling for this requirement to be taken further – not least within the discussions around the European Commission's proposed reforms to the audit market.

We believe that a “fresh pair of eyes” introduces a check on incumbent audit firms’ work, and ensures the audit is not unduly influenced by historical judgments as well as the client’s management; we therefore support the introduction of a legislative backstop which ensures a maximum audit firm tenure.

It is our view that a cap on audit firm tenure would provide an effective and proportionate response to the fundamental problem of misaligned incentives facing auditors identified by the UKCC.

The priority should be to ensure auditor independence is protected and we strongly believe that it should be with the audit committee that accountability for this is placed. In addition, we very much recognise that companies vary in size and complexity and therefore there should be sufficient flexibility within any governance system to allow for this to be accommodated. For this reason we have previously proposed that a company be required to re-tender its audit services approximately every seven years with the provision of a legislative back stop for audit tenure of approximately 15 years. We continue to feel that this approach would be appropriate and proportionate and would thus favour the proposed remedies from the UKCC for tendering after 7 years and rotation after 14 years.

We believe that an introduction of a legislative back stop for audit tenure of 14 years will effectively balance the benefits felt by shareholders, with the costs of disruption borne by the company.

#### Lead partner rotation

It would be sensible to reflect upon the current requirement to rotate the lead audit partner and ensure that this requirement is aligned with any new tendering requirement.

#### A waiver

We consider that a 15 year back-stop for the audit tenure provides sufficient scope for Audit Committees to build in buffers in the event of unexpected crisis. However, we would understand that it may also be pragmatic to allow a tightly controlled mechanism for relief from this cap in extreme cases - any move to apply for such a waiver should be subject to shareholder approval. This issue would also need to be monitored to ensure that it does not become a commonly used mechanism.

#### Phased introduction

The question of what should be the requirements for phasing in this remedy is an important one as it would not be desirable for all firms, or even a majority, of firms to go out for tender at once – it would be highly unlikely that either the audit firms or shareholders would have the resources to cope with such activity. As such, a phased introduction would be a sensible approach and would allow for all involved to learn and adapt to the new environment.

### *3. Expanded remit and/or frequency of AQRT reporting*

As the UKCC’s report notes the AQRT reports are at present the only independent assessment of audit quality that is readily available in the audit market. However, as the report also notes, the audits of many firms, particularly those in the FTSE350 are inspected very infrequently - the average FTSE 350 company is inspected

every 11 years. We therefore see merit in more regular and thorough audit assessments being conducted by the AQRT.

In addition, the suggestion of a more tailored set of publicly available results regarding the performance of all audit firms in the market would be helpful. Providing shareholders with more information as to the 'quality' of the different auditors can only help foster a more effective and true market and improve the understanding of the qualities and performance of the various audit firms amongst their 'client' base – the shareholders.

Another issue worth considering is in relation to the disclosure of the company specific reports to the company's shareholders. While it is appropriate that this information is best left to the Board to assess given the risk of these reports being used to damage a company's interests, we do believe that there is merit in considering how this can be fed back to the shareholders. One solution would be for the Corporate Governance Code to be amended to require the Board to explain how they considered the company-specific review of their audit, including when they last received one, and what actions they have taken to respond to any points made within the report. This would be a similar process to that which has been introduced in relation to Board evaluations.

#### *4. Prohibition of contractual clauses in template documents limiting choice to the Big 4 firms*

We support this measure. Clauses which limit choice only to the "Big 4" are in our view anti-competitive.

#### *5. Strengthen accountability of the External Auditor to the Audit Committee (AC)*

We believe that a key priority should be to continue to strengthen the role of the audit committee and its oversight of the auditor; this has the potential to enhance significantly audit quality and related financial reporting. We believe the UKCC is right therefore to focus on the role of the Audit Committee and to propose remedies which will further enhance its role and influence.

The role of the Audit Committee is crucial in overseeing the audit process on behalf of shareholders. The Audit Committee ought to be robustly independent of management and have the appropriate skills in order to be able to effectively monitor the auditor's independence and objectivity and the effectiveness of the audit process. It should also seek to be open and accountable to the shareholders.

Specifically, we support requirements for the audit engagement partner to report directly to the Audit Committee – it is right that the Auditor should be more directly accountable to the Audit Committee and subsequently also have free and open access to the Audit Committee Chair.

We believe that many Audit Committees are in recent years beginning to take greater ownership of this relationship, however, measures to further clarify the reporting lines of the auditor to the audit committee would be helpful. We appreciate that these increased responsibilities are likely to mean Audit Committees will need to be better resourced, however, as indicated earlier in the UKCC's inquiry, investors on the whole are content with additional cost in return for greater reassurance around the audit quality – a stronger, better resourced and more accountable Audit Committee will go some way to achieving this.

#### *6. Enhanced shareholder-auditor engagement*

While we believe that the primary focus for improving engagement should be between shareholders and audit committees; efforts to increase shareholder involvement in auditor accountability and reporting are also welcome.

#### Introduce a shareholder vote for holding an audit tender

This measure would bring more transparency to the process as shareholders would effectively sanction not just the decision to appoint but also the process to tender. This, along with the tools shareholders currently have to signal their dissatisfaction through direct engagement with the audit committee – a process which should evolve and improve – and the annual re-election of the auditor will provide shareholders with enhanced opportunities to have influence over the audit appointment process.

#### A higher voting hurdle to reappoint the audit firm

Despite votes against auditors being rare – between 2009 and 2011 11 FTSE350 companies received negative votes above 10%, and in 2012 five FTSE350 companies received in excess of 20% dissent in relation to the reappointment of their auditor - we would not be supportive of introducing an increased voting hurdle for this issue.

We would encourage shareholders to utilise all the tools already available to them, including the annual re-election of directors. In addition, efforts are already underway to improve shareholder collaboration and we would expect that if there is sufficient concern about the audit process that investors should be able to come together to ensure their concerns were heard – as has been the case in recent years with executive remuneration.

#### Requiring the lead Audit Partner to present directly to shareholder at AGMs

While it should not be necessary to introduce a statutory requirement that the lead partner present directly to shareholders at the AGM, we do see merit in a statutory requirement for the lead partner to be present.

The lead audit partner is already entitled to be present at the AGM and to be heard at the meeting on any part of the business which concerns him as auditor – shareholders have the power to require website publication of audit concerns which they propose to raise at the meeting. It would not therefore be a significant step to formalise these present arrangements in order to further empower and encourage shareholders to question the auditor on the conduct of the audit; the content of the audit report; the company's accounting policies, and the auditor's independence in relation to the audit. While this opportunity is currently informally available, it is at present very rarely utilised – but is an opportunity shareholders should perhaps seek to utilise more.

#### Requiring the Audit Committee Chair to have a dedicated Q&A item at AGMs

Again we do not believe that it is necessary to require a dedicated question and answer session at the AGM.

We are keen to see audit committees continue to take greater ownership of the audit relationship with enhanced reporting to the company's shareholders of their discussions with the auditors and more willingness to engage directly with investors.

However, if there are genuine concerns, institutional investors will not leave direct engagement with companies to the AGM. Therefore what is most important is improving the quality of reporting from the auditor and audit committee in advance of the AGM.

With this information, shareholders will be in a position to request meetings with the Audit Committee Chair, and perhaps the Auditor – many of whom are now holding useful seminars with shareholders to foster increased dialogue in respect of their own governance.

#### *7. Extended reporting requirements – in either the Audit Committee or auditor's report*

As indicated, we would welcome more informative reporting by both the audit committee and the auditor. Improved reporting would give investors more confidence that auditors have challenged management and that scepticism is working in practice through the reporting of, say, the top ten contentious issues, including some commentary on what had arisen during the course of the audit process. Investors would then be able to engage more appropriately with the company. We are continuing to engage with both the FRC and IAASB as they give further consideration to improvements in this area.

The challenge, as is always the case, will be how to encourage the provision of additional information which adds colour and value and avoids descending down the road of further boiler-plate reporting. The emphasis as always should be on better disclosure rather than more disclosure.

#### **Conclusion**

We welcome the UKCC's rigorous and balanced analysis of the UK's statutory audit services market – this is vital inquiry at an important time. We strongly support the recognition that it is the shareholders who are the "primary customer" of the audit service and that the current market framework is not operating sufficiently in the interests of those end customers.

We endorse the analysis presented by the UKCC and support many of the proposed remedies. We believe that no one solution will achieve market correction, but rather a combination of greater more open tendering, a legislative back-stop for audit firm tenure, fostering of more transparency and dialogue between auditors, companies and shareholders, greater transparency around the performance and qualities of the audit firms in the market; and reform of exclusionary practices should go a long way towards a healthier FTSE 350 audit market. These remedies have all been identified by the Commission and we look forward to working the Commission and others going forward.

**END**