

## STATUTORY AUDIT SERVICES MARKET INVESTIGATION

### Summary of hearing with Nestor Advisors held on 16 May 2013

#### Background

1. Nestor Advisors (Nestor) told us that it was a consultancy focused exclusively on corporate governance and organizational design. It worked with boards and executives of financial institutions, companies and non-profit organizations to improve decision making, organizational structures, controls and incentives. It aimed to maintain a very high standard of independence and had no professional relationship with its clients other than supporting them in designing, assessing, implementing and embedding effective governance.
2. The majority of Nestor's clients were outside the UK. Last year it had three to four FTSE 350 clients.

#### Duties under the corporate governance code

3. It was Nestor's view that the majority of Audit Committees (ACs) relied on management to manage the relationship with the auditor. Most followed any guidance provided by the Financial Reporting Council (FRC) and discharged their obligations primarily by asking questions of management but also by asking questions of auditors.
4. Most ACs met at least once with the auditor, separate of management, but usually with the internal audit team present.
5. Nestor considered that it was too early to observe what impact the latest changes introduced by the FRC had had.
6. Nestor was aware that some investors were seeking to make a point about the quality of the audit through the tendering process and noted comments made by one investor in the press in relation to the recent tender by RSA.

#### Mandatory tendering

7. Nestor supported the introduction of mandatory tendering but noted that every ten years might be too long a time period. It thought that every five years might be too short on the basis that it took some time for auditors to get up to speed. Nestor considered that seven years seemed about appropriate.
8. Requiring a non-Big-4 firm in the shortlist for tenders was a good idea.
9. Nestor did not support open-book tendering on the grounds that it might raise significant legal issues and so increase costs.
10. More transparency was required in relation to the reasoning on which an auditor was chosen in a tender process. The AC report should note how the chosen auditor fared in terms of price compared against other bidders and should also provide reasons as to why the winner was chosen (noting why the best priced firm was not chosen, if relevant).

11. Nestor did not support mandatory rotation of firms, as long as other safeguards were in place (mandatory tendering, shareholder advisory vote, more thorough Audit Quality and Review teams (AQRTs)).

### **Audit committees**

12. Audit Committee Chairs (ACCs) and ACs were generally not on top of the relationship with the auditor. Generally, management managed this relationship. Nestor considered that the AC needed to interest itself more in the staffing issues of the audit process and that all issues needed to be reported to the ACC.
13. More meetings needed to take place, without management, between the AC and the auditor. However, if this was going to be the case, then it was likely to lead to an impact on the time required of the AC. The AC would also likely require more specialist support. At the moment all support was provided by the general company secretariat. Nestor considered that a specialist within company secretariat might be needed.
14. In large companies, requiring just a rotation of the engagement partner on partner rotation might not be enough. Other partners, closely involved with the specific audit client should also be required to rotate. Nestor suggested that such staffing issues were not discussed by the AC or how staffing more generally was likely to influence output. The concept of the ACC as a 'fresh pair of eyes' might not be working.
15. Some ACs tended to provide guidelines to management on its expectations on independence and then left it to management on trust to operate accordingly. Others were much more hands on and insisted on approving all non-audit work, over a de minimis value, conducted by the auditor.
16. ACCs would require a significant level of support if they were to take on independently and exclusively responsibility for fee negotiations in addition to all of their other existing or anticipated duties. This type of hands-on responsibility might lead to the members of the AC being quasi-employed by the company, rather than remaining as non-executives. Nestor noted that this had become the case in Turkey, where ACs directly oversaw the functions of external audit, internal audit and risk management. A responsibility just to manage fee negotiations might be more manageable, if it had a sufficient level of specialist company secretariat support. Nestor noted that in large international banks, the number of AC meetings required over the last ten years had doubled.

### **AQRT reviews**

17. The AQRT needed to significantly broaden the firms that it assessed. The assessment of the non-Big-4 firms at the moment was rudimentary.
18. AQRT reviews were never mentioned in discussions and were not seen as a resource at company level. Having AQRT reviews prepared ahead of tenders might be a good idea. Nestor also noted that AQRT reports should in the future be drafted with such extensive use by ACCs in mind.

### **AGMs**

19. Nestor did not think it was a good idea to change the voting requirements of shareholders at AGMs in relation to auditor appointments/reappointments. It might lead to quorum issues and requirements for repeat meetings. Advisory votes might be a

better option, as existed in relation to the remuneration committee, to identify issues with the auditor or express a requirement to tender the following year. Advisory votes could also be introduced with respect to the contents of the audit report.

20. Nestor did not think there was much shareholder appetite to question the ACC or Audit Engagement Partner at AGMs. Such a requirement was unlikely to change much or add much pressure on auditors to perform. It did not consider that was an effective way of opening up or contesting the auditor selection process. ACCs and engagement partners would simply arm themselves with advisers and make the process more costly—eventually to shareholders.
21. Nestor suggested as a potential alternative the consideration of the Swedish approach which had shareholder committees instead of the board/ACC selecting and holding accountable the auditors. These committees were appointed among representatives of key shareholders at AGMs.

### **Barriers to entry**

22. Nestor considered that the provision of non-audit services by the Big 4 firms was a significant barrier to audit market entry and suggested that greater limits needed to be applied on the provision of non-audit services. This was because: (a) they increased scale/scope requirements at entry, because management required capacity to provide such services; and (b) management (the basic client of non-audit services) required such capacity because they provided management with significant leverage on audit-related decisions by the auditor. In order to minimize market distortion by a structural remedy of this sort, such limits would be proportional to the size of an audit's firm market share in the audit market. This would give non-Big-4 firms more opportunity to penetrate FTSE 350 companies and better understand large listed company requirements over time.