Association of British Insurers

# AUDIT SERVICES MARKET INVESTIGATION

## The ABI's response to the Competition Commission's preliminary report on the statutory audit services market

### Introduction

1. The Association of British Insurers (ABI) welcomes the opportunity to comment on the Competition Commission's preliminary report as it finalises its investigation of the audit market.

2. The ABI represents the UK's insurance, investment and long-term savings industry, the largest in Europe and the third largest in the world. It has over 300 members, accounting for some 90% of premiums in the UK domestic market. As institutional investors with some £1.6 trillion of assets under management, we have a strong interest in seeing a competitive market in audit services that delivers a high quality product that will underpin confidence in the accuracy and fairness of financial statements.

### General comments

3. It is important that auditors serve the interests and needs of investors effectively. We therefore welcome the consideration of remedies aimed at supporting this. The high level of concentration in the market for audit of major listed companies extends to the FTSE Mid-250 as well as the FTSE 100, where the size and complexity of companies makes the engagement of a top-tier auditor more appropriate. The four largest firms do, in our opinion, command a material degree of market power.

4. It is not clear that a market dominated by four firms is in the best interests of investors. Accordingly, we supported the undertaking of a Competition Commission review in the UK. However, in view of the international nature of the market structure, we would support a wider EU review. It is important that any statutory measures take account of regulatory developments in other markets, to ensure that there is a coordinated approach to the global regulatory regime.

5. The scope for competition and choice may be constrained by business conflicts or capacity issues that prevent some accountancy firms from being appointed as auditors to major companies. In some sectors, including banking and finance, where need for technical expertise makes the barriers to entry high, there may be particular concentration.

6. Audit appointments (not just by FTSE 350 companies but more widely) may be longstanding and there is a risk that this may not always be for good reasons. Customer conduct – or inertia - may be limiting competition. However, this is more a governance than a competition issue. The introduction of a 'comply-or-explain'

regime to ensure that audit appointments of more than 10 years without tendering are given adequate scrutiny, as implemented by the FRC, strikes the right balance. The early signs are encouraging and we believe this approach should be given more time.

7. While we support the Competition Commission's focus on enhancing the role of shareholder oversight, the remedies proposed require careful thought. Rather than formal mechanisms that focus on shareholder rights and the role of the AGM, we would favour increased shareholder engagement and a continued focus on equipping shareholders with meaningful disclosure. We would support consideration of how to support shareholder engagement in these matters as part of the next review of the Stewardship Code review.

8. Improving shareholder engagement also requires improved provision of information and transparency over judgements. Information asymmetry that affects the assessment of audit quality and the capabilities and expertise of audit firms is being addressed through the development of improved reporting. The work being undertaken by the FRC on Audit Committee and Audit Reporting, facilitated by the FRC's Financial Reporting Lab, is welcomed and should be given time to demonstrate improvements. In regard to the audit report, we commend the work that has been undertaken on a global basis by the International Auditing and Assurance Standards Board (IAASB).

9. A particular concern about market concentration is the likely impact of a Big Four firm leaving the market. We share the concerns expressed by the OFT and the House of Lords in its recent report *Auditors: Market concentration and their role*, that the failure of an existing Big Four firm would further increase concentration. Avoiding this should be a particular goal for the competition authorities. However, it would not be acceptable for major firms to be treated as 'too big to fail'. This could involve such firms being shielded from competitive and market forces further. The recognition of this risk is clearly informing developments in current thinking about 'living wills' for the largest firms, which we support.

10. We are concerned by the Competition Commission's consideration of mandatory rotation. ABI members remain sceptical that this will have the desired effect of improving auditor choice. There is also concern over unintended consequences. Mandatory rotation is likely to be costly and disruptive and may expose shareholders to the risk of a new auditor at the wrong time, or even conceal the real reasons for another auditor stepping down.

11. We would, however, support measures that increased the efficiency and reduced the risk of tender processes. The proposal for 'open book' tender processes is worth further consideration, but careful consideration will have to be given to the potential commercial sensitivities for both companies and auditors.

**Mandatory tendering / rotation**

12. ABI members supported the recent changes to the FRC's UK Corporate Governance Code to require, on a 'comply or explain' basis, FTSE350 companies to put their audits out to tender every ten years. We believe this strikes the right balance and could improve competition. The early signs of this are encouraging and we believe it should be given more time. We reject the notion advanced in the paper that 'comply or explain' undermines effective compliance. The FRC's most recent survey demonstrated a 90% compliance rate with the Code – but cogent and coherent 'explanation' should remain a valid approach.

13. The current incumbent should be allowed to retender but it is undesirable that the position whereby audit firms retain a FTSE 100 client on average for 43 years should continue. There should, however, be more accountability and transparency to shareholders on the tendering process. For example, some major investors may wish to be consulted on the appointment process and, for example, the major aspects which the Audit Committee will be reviewing and using to compare firms.

14. As well as information on the tender process, shareholders would welcome greater clarity on how the relationship between the auditor and the company is governed. For example, companies could outline how it ensures that the Audit Committee has an appropriate level of access to the auditor and oversight of key judgement.

15. In the UK, auditors are appointed each year by shareholders. This authority is valued by investors. However, it is doubtful whether the current provision of information, both in the Audit Committee Report and the Audit Report, enables an informed vote. We support the project being undertaken by the FRC's Financial Reporting Lab to work towards meaningful disclosures and avoid boiler-plate. This should enable greater scrutiny of audit quality and help to overcome asymmetric information.

16. Mandatory rotation would be likely to be costly and disruptive. Companies could be forced to change auditor at a time when the existing auditor's familiarity with the business would benefit the audit, such as when there is a major acquisition or merger. It could also conceal the fact that an auditor has stood down for a particular reason and prevent auditors being reappointed when they are the preferred choice of both the Board and investors.

17. Audit Committees should be allowed, with appropriate shareholder engagement, to secure the best auditor for their business and this should not be artificially constrained. Rather than undermine the role of the Audit Committee by taking decisions away from them, there should be greater focus on empowering their oversight role and access to information.

18. We support consideration of increased time-commitment of Audit Committee Members and, in particular, the Chairman of the Committee, as envisaged in paragraph 49 in the Notice of Possible Remedies. In general, we support greater

flexibility on the time-commitments required of non-executive directors. We believe there are cases where increased time-commitment will be appropriate and is likely to support better stewardship outcomes.

19. It is also unclear whether the rotation alone will lead to increased competition, particularly in the large cap market. For instance, it is unclear whether mid-tier audit firms are contemplating the investment to achieve the scale needed to compete in the large cap market.

20. In principle, we have no objection to conducting tendering on an 'open book' basis; however, companies may object on the grounds of commercial confidentially and may, for example, favour a certain auditor because of their long-standing trust in the private and confidential nature of their service.

**Expanded remit and/or frequency of Audit Quality Review team (AQRT) reviews**

21. A strong and transparent inspection regime is important in giving confidence to investors. However, the UK's AQR regime is generally considered to be a global leader and it is unclear whether a move away from its focus on Companies considered to be a priority risk will lead to better outcomes. We would support the consideration of more frequent AQR inspections of higher risk priorities and the provision of more detailed reporting to stakeholders. This would of course require appropriate funding to be meaningful.

**Prohibition of 'Big 4 only' clauses in loan documentation**

22. We support this proposed remedy.

**Strengthened accountability of the External Auditor to the Audit Committee (AC)**

23. We favour strengthening the accountability of the external auditor to the Audit Committee. We supported this in the recent changes to the UK Corporate Governance Code, which increased the responsibility of the Audit Committee and its need to demonstrate to investors how it discharged oversight of the external auditor.

24. The introduction of extended reporting requirements for both auditors and Audit Committees has increased the extent of matters on which auditors are required to report to Audit Committees and, in turn, the matters that Audit Committees are required to address to investors. The ABI will be contributing to the FRC Financial Reporting Lab project in this regard.

25. Nonetheless, it is important that this does not serve to weaken indirectly the primary responsibility of auditors to report a 'true and fair' view to shareholders and, furthermore, to report when they remain concerned that matters have not been adequately resolved by the Audit Committee.

**Enhanced shareholder-auditor engagement**

26. We support the underlying principle of enhanced shareholder engagement but have reservations over the remedies proposed.

27. We are concerned that the proposal to enable a vote on holding a tender may undermine the role of the Audit Committee in making an appropriate judgement. The proposal to increase the required level of support in cases the same auditor remains in place following a tender process is also problematic. This may present an opportunity for a disruptive shareholder to force a tender unnecessarily with the intention of destabilising the Board, which may create uncertainty and be detrimental to overall shareholder interests.

28. In respect of the proposals relating to the AGM, although sympathetic to the spirit of such an approach, we are concerned that such communication would likely be boiler-plate in nature and that institutional investors are generally unable to attend AGMs, given the number that are held over a short period of time.

29. Rather, members would support consideration of how to support shareholder engagement in these matters as part of the next review of the Stewardship Code. This should also be considered in conjunction with review of the Corporate Governance Code, to ensure the two are complementary. For example, it may be appropriate to advance the expectation that the Audit Committee make itself available to shareholders as a form of best practice.

30. The current level of shareholder focus on audit and accounting issues is something the ABI will be seeking increasingly to facilitate among its members. We are optimistic that engagement in this area is likely to increase in intensity and sophistication over time, particularly if there is appropriate incorporation as part of the Stewardship Code. However, such engagement will also require enhanced Audit Committee reporting to equip shareholders with the relevant information to challenge.

**Extended reporting requirements**

31. We welcome the work of the FRC is this regard and consider them to be best placed to formulate appropriate recommendations.

ABI
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