USS
UNIVERSITIES SUPERANNUATION SCHEME LIMITED

UK Competition Commission inquiry into Statutory Audit Services: Possible remedies

19 March 2013

1. Introduction

This document is being submitted on behalf of 8 institutional investors in the UK, responsible for managing approximately £180 bn assets on behalf of our members and savers[1]. We are all long term owners in UK listed companies, and share an intrinsic interest in reliable and high quality audits for the companies in which we invest. We look to the audit to provide us with reassurance that the accounts presented by companies are robust and reliable, providing a “true and fair view” of capital and recent performance.

We welcome the UKCC’s Provisional Findings report on the statutory audit market for large companies (22 Feb 2013). In particular, we welcome the attention to the disconnect between the fact that the shareholder is the “primary customer” of the audit, but is rarely the target audience for auditors as they seek new audit contracts, or consider ways in which to improve audit quality. Indeed, the UKCC rightly highlights misaligned incentives between auditors and shareholders, and the risks that this poses for independence, professional scepticism, and ultimately audit quality.

Alongside the Provisional Findings report, the UKCC put forward a Notice of Possible Remedies (22 Feb 2013). The document sets out a list of remedies the UKCC is actively exploring to address the identified market shortcomings. It also highlights remedies that it has effectively ‘put on the backburner’, unless it can be persuaded that these remedies are “effective” and “proportionate”.

This submission puts forward our views on the identified possible remedies. Specifically, we set out our support for:

- An outer limit on audit firm tenure of 15 years, supported by a competitive tender, as the most effective remedy being considered (Remedies 1 and 2);
- Other measures to improve transparency for shareholders (Remedies 3, 6 and 7), including consideration of whether AQRT reports should be made available to shareholders, and the right for shareholders to put questions to auditors that are answered at the AGM;
- Steps to strengthen the Audit Committee’s oversight of the auditor (Remedy 5);
- A prohibition of ‘Big 4 only’ clauses in loan documentation (Remedy 4).

In addition, in section 6, we urge the UKCC to reconsider its decision to reject measures to limit non-audit work undertaken by the audit firm. These should be explored as an effective measure for addressing an important source of potential conflicts of interest.

Our submission is provided from the perspective of long-term shareholders and, thus, is focused on ensuring independent high quality audits. Our interest in this topic is reflected in past submissions to

[1] Please refer to the end of the document for the full list.

the UKCC[2], as well as our support for an investor Position Paper on the EC's proposed audit sector reforms. As of 22 February, the latter has support from over 30 institutional investors, managing approximately GBP 1.8 trillion[3].

While we have focused on shareholder accountability, we believe that this is intimately intertwined with improving competition in the audit sector. Indeed, as the UKCC highlights, accountability is a prerequisite for achieving a competitive audit market that delivers for the ultimate client. Strengthened shareholder accountability would help ensure audit firms compete on those parameters that are important to shareholders, resulting in greater choice and innovation around the factors that matter to shareholders.

We also believe that a less concentrated market is desirable, to encourage auditor responsiveness to shareholder needs; to counter the possibility of excessive charging (and related "supernormal profits"); and to reduce risks in the event that one firm goes bankrupt.

We recognise that our proposals cannot provide a "silver bullet" for tackling misaligned incentives and market failures in the audit sector. We do believe, however, that they move us in the right direction. For the most part we can see that additional support may be required to overcome barriers to entry facing smaller players, but whatever action is taken, the shareholder should remain 'front and centre' in the market for audit.

2. Competitive tenders and a cap on audit firm tenure (Remedy 1 and 2)

2.1. Our proposal[4]

As mentioned, a large and growing coalition of investors has come together to support a number of proposals to reform the EU Audit Market. These include a proposal for an outer cap on audit firm tenure of 15 years. This upper bound is intended to be long enough for Audit Committees to have the scope to set a maximum tenure period to suit their company's complexity and size, and provide sufficient time for flexibility in the event of an unexpected crisis. The 15 year upper bound is effectively a 'back-stop' to safeguard shareholders long term interests.

It is expected that Audit Committees will undertake at least one competitive tender including the incumbent, and then again at the end of the full term, excluding the incumbent. There should be a 'clear water' period of at least 5 years before an auditor can be re-appointed. Audit Committees should outline their reasoning for the choice of tenure length to shareholders.

2.2. Rationale

As already emphasised, we believe audit quality (and ultimately trust in capital markets), depends on real - and perceived - auditor independence. Independence provides a basis for ensuring professional scepticism and prudence in analysis and willingness to robustly challenge management.

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[2] See for instance USSIM's submission to the UKCC on 9th May 2012, which includes a discussion of key possible remedies.

[3] Please see "*Audit – a long-term investor position paper on proposed EU reforms*", 22 Feb 2013.

[4] Ibid; See also the recently revised National Association of Pension Funds' position paper on proposed EC reforms on audit, which sets out NAPF's support for mandatory audit firm rotation after 15 years.

Currently, it is very difficult for shareholders to ascertain whether auditors are independent of the executive, whose accounts they are employed to scrutinise. Audit Opinions are boiler-plate and shed little light on the discussions that take place between audit partners, company management, and Audit Committees.

It is widely accepted – including in the UKCC's report - that the audit process needs to become more transparent. Transparency is critical to ensure independence of the auditor from executives and from their own historical judgments, and also to provide a basis for shareholders to hold auditors to account. The majority of investors find the average length of tenure in the FTSE 350 to be excessive, and would like to see increased rotation of audit firms[5].

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.

2.2.1. Mandatory cap would be effective

An upper limit on audit tenure would be effective because it would introduce a certain and regular check on the incumbent auditor's work[6]. The result of this "fresh pair of eyes" would be:

- information that shareholders could use to hold outgoing auditors to account for past work; and, consequently,
- a fundamental shift in accountability to shareholders.

We are not aware of any other system that would be as effective in delivering this structural shift in the market, and effectively providing the tools and incentives for self-regulation. Two alternatives that are mooted would leaving shareholders facing excessive audit risk (if implemented on their own). These are: 1) a reliance on more rigorous regulatory checks, and 2) mandatory competitive tenders[7].

1) More rigorous spot checks by a regulatory authority

Whilst more frequent and rigorous checks are a good idea (see our views in Section 3.1.1 below), these are unlikely to attain the requisite level of coverage and depth that an incoming audit firm would. As the UKCC notes in its Preliminary Findings, FTSE350 companies are checked on average only every 11 years. They are also not directly answerable to shareholders. Indeed, shareholders never see company-specific inspection reports so gain little detailed information on the audit risks in the companies that they hold. As the audit quality check is important due to the 'public good' role of

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[5] According to the UKCC's latest data in its Preliminary Findings, 31% of FTSE 100 (20% of FTSE 250) have the same auditor for over 20 years, and 67% (52%) have the same auditor for over 10 years.

[6] The check, of course, comes once the incumbent auditor is replaced by a new auditor. Despite this time lag, the outgoing auditor is still held accountable for its past decisions, and this is likely to provide a powerful control on behaviour when they are the incumbent auditors.

[7] We do not address audit partner rotation, which is already in place in the UK, as we are looking for new measures to tackle the lack of accountability to shareholders that currently exists. Needless to say, we consider audit partner rotation alone as inadequate to deliver a "fresh pair of eyes" since an incoming partner is highly unlikely to challenge judgments and policies adopted by his/her predecessor as this may well impinge on career development, a firm's reputation and even risks of litigation.

audits, it is also important for shareholder protection in individual companies. Shareholders should be able to rely on an independent third-party review for the companies they hold.

2) Mandatory competitive tender without a cap

We support mandatory tenders as a complement to a cap on audit firm tenure (See Section 2.1). However, we have reservations as to whether this on its own will restore auditor accountability to shareholders.

Ultimately, most investors see rotation of audit firms as desirable to delivering a shift in accountability to shareholders. However, as long as we have a principal-agent divide and diffuse share ownership (two key market failures), we are not persuaded that competitive tendering can be relied upon to deliver rotation. The incumbent would have important natural advantages in any tender. Moreover, the risk that such a tender – without any certainty over an incumbent firm's departure date – could exacerbate the perverse incentives facing incumbents to support company executives should not be underplayed.

Given the importance of the audit to the integrity of financial statements, we believe there is a strong case for a mandated cap on tenure as a shareholder protection mechanism.

2.2.2. Would a tenure cap undermine choice?

Arguments against a mandatory cap often point to the fact that this would limit companies' and shareholders' 'freedom of choice'. The matter turns into one of 'choice' versus the heavy hand of the state imposing inflexible rules. This, it is argued is problematic, since the lack of flexibility could result in a change in auditor that shareholders do not want, and which results in a reduction in audit quality. In other words, those arguing against a cap believe it would be counter-productive.

We understand the logic behind these arguments, and have sympathy with the preference for choice over rules. However, we consider this to be a false comparison since the 'free market' position we find ourselves in does not, in fact, provide shareholders with a genuine choice or real control over the auditor or audit process. Market failures associated with asymmetric information and diffuse ownership are severe and shareholders in this situation require protection.

Whilst our priority is to ensure auditor independence is protected, we also wish to ensure the Audit Committee has scope for flexibility. Consequently, our proposal is not for a fixed term, but for an outer-bound cap which would provide adequate tenure periods for complex firms, and for unforeseen circumstances. We feel that a tenure beyond 15 years introduces excessive risks to independence and audit quality.

2.2.3. Mandatory cap at 14 or 15 years would be proportionate

The question of proportionality boils down to costs, and whether the costs of disruption from changing the audit firm, and associated risks to audit quality, outweigh the benefits to shareholders from reassurance over independence and accountability.

A critical consideration here is the frequency that change is mandated. The UKCC puts forward alternative term limits of 7, 10 and 14 years. Given our own proposal for a 15 year cap (please see the view of the costs and benefits of switching set out in USSIM's original submission, 9th May 2012), we favour the longer limit of 14 years. The shorter periods fail to strike the appropriate balance between the wish to increase accountability of the Audit Committee, and allowing companies sufficient scope for flexibility as noted above. Fourteen years also provides sufficient time for more complex firms to manage the change-over process and audit risks associated with this. In other words, the longer tenure limit balances the benefits felt by shareholders, with the costs of disruption borne by the company.

2.2.4. A possible waiver

As already noted, we consider a 15 year outer limit of tenure provides sufficient scope for Audit Committees to build in buffers in the event of unexpected crises. However, we would not oppose a tightly controlled mechanism for relief from the cap in extreme cases, and with approval from the regulator. Care should be taken, however, to prevent this from becoming a routine "opt out" of the 14 or 15 year rule. Ideally, any move to apply for such a waiver should be subject to shareholder approval.

2.2.5. Independent director term limits – a precedent

It is worth stressing that there is no "right" answer when it comes to tenure length. It is rather a process of considered analysis of the costs and benefits for different terms, a review of empirical evidence, and - ultimately - a judgment of risks. To dismiss any specific limit as "arbitrary" fails to reflect the fact that any limit in any area, be it term limits for elected officials, or indeed independent directors in the UK, is the product of careful weighing up of costs and benefits. For the most part, investors in the UK are supportive of a 9 year limit for independent directors for companies, after which we tend to view risks to independence as excessive. The same logic may be applied to audit firm terms.

2.2.6. Phased introduction

The process by which mandatory caps on audit firm tenure are introduced will need to be carefully considered. Clearly, it will not be desirable if all firms go out for tender at once. The market will take time to respond, as expertise is built. A phased introduction would seem sensible, taking account of the numbers involved as well as the sector expertise that may be required.

3. Other measures to increase disclosure on the audit to shareholders (Remedies 3, 6 and 7)

We are supportive, in principle, of the other proposed measures under Remedies 3, 6 and 7 that improve transparency around the audit process for shareholders. However, we should stress that we view the rotation of the audit firm to be the most effective mechanism for delivering vital information on auditor's performance, and we would not wish to see rotation replaced with a less rigorous system of checking. Indeed, some of the proposals would become redundant in the event of a tenure cap being instituted (these are highlighted below). Nevertheless, the additional proposed measures would certainly support the opening up of the audit market. Below, we set out our thoughts on each of the proposals.

3.1.1. Remedy 3: Expand remit and/or frequency of AQRT reporting

The Audit Quality Review Team (AQRT) at the FRC offers an important regulatory check on the audit market. The AQRT's spot checking system seeks to ensure audit firms remain accountable, and deter any reduction in auditing standards either to cut costs or as a result of auditors getting too close to executives. In essence, the AQRT aims to make up for the inability of shareholders to properly hold auditors to account due to information asymmetries.

Yet, as the UKCC's Preliminary Findings Report emphasises, the AQRT cannot provide full coverage on an ongoing basis. It necessarily relies on spot checks. Over the 5 years to March 2013, an average FTSE 100 company was inspected once every 6 to 7 years, while the average FTSE 350 company was inspected on average every 11 years. This level of checking is no doubt helpful, but fails to provide the level of reassurance shareholders require over audit quality. Moreover, we do not believe that it sufficiently counters potential conflicts of interests.

Our view: We would, therefore, support more regular and thorough checking. However, were a mandatory audit firm cap put in place as proposed above, the audit system would become largely self-regulated, and may reduce the need to devote additional resources to the AQRT.

AQRT company reports should be made available to shareholders

We would also like to highlight an additional point not explicitly addressed in this Remedy. While AQRT summary reports on the Big 4 are made available annually (and perhaps every 2 to 3 years for the mid-tier firms), company specific reports are not made available to shareholders. It seems to us a strange situation where the ultimate audit clients are not permitted to see the inspection report on their own auditor's performance in a company. We believe this state of affairs needs to be revisited, especially in light of the need for shareholders to be in a position to hold audit firms and Audit Committees to account.

3.1.2. Remedy 6: Enhance shareholder-auditor engagement

Below, we look at the individual proposals under this remedy.

Shareholder vote for holding an audit tender

While this measure might appear to provide shareholders with greater say in the audit process, problems of diffuse share ownership and poor information around audit mean that in practice it will be unlikely to provide a meaningful check on auditors (see point below on a higher voting hurdle). Consequently, we believe that this measure is likely to be less effective than the UKCC's proposed Remedies 1 and 2.

High voting hurdle rate (>50%) of audit firm reappointment

A move to a supermajority (75% or more) could be a welcome step in light of problems of diffuse ownership, but would require further consultation. Votes against auditors are rare, even in cases where failures are well known. Overall for the FTSE 350 for 2009-2011, there was an average 1% vote against auditor appointment/ reappointment or auditor remuneration related matters. Only 11 companies had votes against above 10%, and only 1 was above 16% (and this should be considered

an outlier since it resulted from a dominant shareholder voting against almost all resolutions at the company). This level of voting is similar for every year since 2006.

Requiring the Auditor to be present at the AGM & to have a dedicated place on the Agenda
These requirements may provide useful physical reminders to auditors that they are ultimately accountable to shareholders, but it is worth remembering that in practice most institutional investors will rarely leave direct dialogue with companies to the AGM. Instead, we seek to ensure greater accountability through requests to meet with Board Directors at key points in the year. In general, therefore, the more relevant and effective requirement would be around auditor disclosures prior to the AGM, most likely in Annual Reports on key matters of substance in the audit (e.g. levels of materiality, key judgments, areas of discussion with the Audit Committee and auditor's views on important audit risks) as well as the audit process. With this information, shareholders will be in a position to hold more fruitful meetings with the Audit Committee Chair, and perhaps the Auditor. Shareholders should, however, have the right to put questions to the auditor prior to the AGM, and the auditor should then be required to be present to answer these questions.

3.1.3. Remedy 7: Extending reporting requirements –the AC's or auditor's report

As already highlighted, we welcome any measure that can increase transparency for shareholders around audit. However, it is vital that the increased information flow provides new and real insights into audit quality and/or the performance of the Audit Committee, and does not become a list of boiler plate pronouncements focusing on process rather than substance. We are particularly interested in additional information relating to key areas of audit risk, significant judgments and rationale for the approach taken, other areas of focused discussion by the Audit Committee and levels of materiality used by the auditor. We are individually contributing to consultations on the issue of disclosure by auditors and Audit Committees being managed by the FRC and others.

4. The Audit Committee as a check on auditors (Remedy 5)

The Audit Committee plays a critical function in overseeing the audit process on behalf of shareholders. Set up to manage the principal-agent problems that exist in listed companies, the Audit Committee must have the power and ability (in terms of skill set, independence and willingness to challenge) to hold executives and the auditor to account. It must also itself be accountable to shareholders through full and frank disclosure of pertinent information around the audit.

Our view: We welcome the UKCC's focus on the Audit Committee, and support the specific proposals set out in Remedy 5 to reduce as far as possible the influence of the executives over the relationship between the auditor and Audit Committee. Specifically, we support requirements for the audit engagement partner to report directly to the Audit Committee. Moreover, it is clearly very important that the Audit Committee retains control over audit firm and partner selection and fee negotiation discussions and decisions. We would also like to see further consideration of how "no surprise policies" at firms do not impede direct access to the Audit Committee where necessary.

While we appreciate that these increased responsibilities are likely to mean Audit Committees are better resourced; this is a price worth paying for greater clarity over lines of responsibility and – for shareholders – reassurance that the Audit Committee is performing its proper oversight role.

5. Remedy 4: Prohibition of "Big 4 only" clauses in loan documentation

We support this measure as any Big 4 only limitations in loan documentation are in our view anti-competitive.

6. Limits on non-audit work by the audit firm

We would encourage the UKCC to reconsider its assessment that limits on non-audit work are not likely to be effective or proportionate remedies. We believe that the prospect of winning lucrative non-audit contracts poses a potential conflict of interest for incumbent audit firms. For this reason we support the proposal in the investor coalition Position Paper (referred to in the Introduction) for an upper threshold for non-audit to audit fees at any particular client of 50%. We appreciate that there are already guidelines around "black-listed" non-audit services that auditors should not engage in. However, we consider any non-audit work as generating perverse incentives for the audit firm, and for this reason propose an across the board limit.

The UKCC's rationale for not including a limit on non-audit work seems to boil down to two reasons:

1) There is no clear evidence that non-audit work is more profitable than audit work, so the incentive impact is more muted than many believe.
2) Non-incumbent audit firms often gain exposure to potential clients, and build relationships, through non-audit work, which is thus an important mechanism for over-coming barriers to entry, especially for the mid-tier firms.

While we are not in a position to comment on whether the audit work is as profitable as non-audit work in terms of margins and rates of return, we are more circumspect regarding overall levels of profits achieved. The audit contract is relatively "commoditised" in that the parameters of what is required for an audit are standardised. Clearly, the amount of work will rise with the size and complexity of the client, but - at the end of the day - an audit is an audit. Non-audit work, in contrast, may start with some small consultancy around, say, an IT systems or business strategy, and develop into large scale rolling-out of recommended action with fees rising to multiples of the audit contract. So, while it may be true that margins are comparable for audit and non-audit work, the potential future profitability for non-audit may well exceed the audit work. This poses a risk to auditor independence. At the same time, it is not clear to us what shareholders gain from taking on this risk.

Turning to the question of the need to address barriers to entry through non-audit contracts, we would not have a problem with a non-audit service provider bidding for an audit contract at the same company. We would, however, expect that in the event that they won the audit contract, that they would have an exit strategy for relinquishing the non-audit work over a reasonable period. Moreover, it would be possible to introduce transitional requirements for achieving limits to non-audit work by auditors in a way which does not disadvantage smaller audit firms from entering the market.

7. Summary and concluding remarks

We welcome the UKCC's detailed and analytically robust analysis of the UK's large audit market. We especially appreciate the emphasis placed on the need to re-establish accountability to shareholders. This shift is long over-due. For many years regulators have sought to address widely appreciated conflicts of interest in the market, and risks to auditor independence. However, there has been a failure to highlight the equally important need to establish accountability of auditors to shareholders. The UKCC's report clearly places shareholders 'front and centre'. In the end, accountability to shareholders will only be achieved where the incentive framework aligns auditors with their ultimate client.

We support the majority of proposed remedies put forward by the UKCC. We believe that the emphasis on an outer cap on audit firm tenure, supported by increased disclosure by the auditor and Audit Committee, directly tackle the problem of a lack of auditor accountability. We are in favour of a 14 or 15 year time frame for any tenure cap to permit the Audit Committee scope for flexibility.

We would also support more rigorous checks by the AQRT, and believe the disclosure of AQRT company-specific reports to shareholders should be explored. Equally, measures to increase the power and independence of the Audit Committee would be enormously positive. 'Big 4 only' clauses in loan agreements should be prohibited.

Finally, we urge the UKCC to reconsider its decision that measures to limit non-audit work undertaken by the audit firm would be less effective. Such limits would directly address a core source of conflicts of interest facing auditors.

As emphasised by the UKCC, the establishment of an incentive framework that supports auditor accountability to shareholders is vital to ensure a healthy and competitive market. Indeed, it is the disconnect between the beneficiary and payer that is perhaps the most difficult market failure to tackle. Our proposals to restore accountability are, therefore, a critical component of promoting competition and, ultimately, high quality audits.

We recognise that other measures may be necessary to open the market to smaller players. We hope they offer insights, nonetheless, on key characteristics of an audit market that serves the interests of long-term shareholders. At the end of the day, we wish to ensure a rigorous and independent review of management accounts that provides reliable reassurance that the accounts provide a "true and fair view" of the underlying health of a company.

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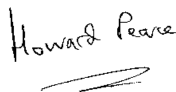

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