



## AUDIT SERVICES MARKET INVESTIGATION

### The ABI's response to the Competition Commission's provisional decision on remedies

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#### Introduction

1. The Association of British Insurers (ABI) welcomes the opportunity to comment on the Competition Commission's ("CC") provisional decision on remedies as it finalises its investigation of the audit market.
2. 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 and underpins confidence in the accuracy and fairness of financial statements.

#### General comments

3. The purpose of the statutory audit is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements. As their ultimate clients, it is important that auditors serve the interests and needs of shareholders effectively. There is a clear risk that a market dominated by four firms may fail to achieve this and, furthermore, were one of the top-tier firms to fail, the impacts would run far wider than competition alone. We, therefore, hoped that the CC would seek to advance choice in audit and are disappointed that the remedies are unlikely to do so.
4. Furthermore, it is important for shareholders to retain their position of primacy over key agency relationships and decisions. We are concerned that the current remedies risk the regulator acquiring a disproportionate influence over the process of auditor appointment and quality and, ultimately, the Audit Committee. This is unlikely to be in the long-term interests of shareholders or competition.
5. Shareholders continue to believe that the appointed Audit Committee is in the best position to represent their interests in overseeing audit matters. It is, however, important for shareholders to continue to ensure that the Audit Committee serves their interests. This relies on an appropriate provision of information and, for a long time, shareholders have found disclosure insufficient. Therefore, it is important for companies and shareholders to work together to improve disclosure under the new FRC's UK Corporate Governance Code (the "Code") and ISA requirements coming into effect.

6. ABI members are concerned by the CC consideration of mandatory re-tendering every five years. They doubt that this will have the desired effect of improving auditor choice. The Financial Reporting Council undertook a thorough consultation process before concluding that a 10 year period, on a 'comply or explain' basis, was in the interests of companies and shareholders and, importantly, would help preserve audit quality. We support this position.
7. The evidence to date suggests that this approach is increasing the number of retenders and shareholder dialogue on audit matters is improving. However, as a backstop, the ABI would support a mandatory requirement for the Audit Committee to undertake a tender process after 15 years. In the absence of a change in auditor following a retendering after 15 years, a minority of ABI members believe that it may then be appropriate to require a mandatory rotation in the auditor after 20 years.
8. Overall, we believe that the 'comply or explain' approach, underpinned by the drive towards improved provision of information to shareholders, should be given more time to demonstrate improvements.
9. Members believe that the most effective method of stimulating choice and competition would be to require a mandatory reduction in market share of the Big Four.
10. We respond to each of the proposed remedies below.

#### **Mandatory retendering every five years**

11. The CC considers it to be a matter of judgement as to the appropriate interval between tender processes. ABI members continue to believe that the Audit Committee is in the best position to make such a judgement, taking into account the particular circumstances of the company concerned. We do not believe that such a judgement can be made on an *a priori* basis.
12. The Audit Committee does, however, have an important responsibility to demonstrate to shareholders how it continues to assess the effectiveness of the external audit and ensure objectivity and independence, as now required under the FRC's UK Corporate Governance Code.
13. On this basis, 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. This strikes the right balance and, rightly, puts the emphasis on the Audit Committee to explain its retendering position.
14. Within this framework, there should, however, be more transparency and accountability to shareholders:

- a. the Audit Committee should make clear its position regarding retendering; the merits of which, and the appropriate intervals, are likely to be Company specific rather than determined *a priori*;
  - b. some major investors wish to be consulted on the appointment process and the aspects which the Audit Committee will be reviewing and using to consider audit quality and otherwise compare firms;
  - c. the Audit Committee should also consult with its largest shareholders on other key audit and accounting matters;
  - d. information concerning how both the tender process was undertaken and key areas of consideration should be disclosed to shareholders in the Audit Committee Report.
15. We consider these proposals to fall under the new Corporate Governance Code requirement to describe, on a comply or explain basis, the work of the Audit Committee and, specifically, the approach to appointing the auditor. This is being actively considered in our discussions with the FRC's Financial Reporting Lab's project to develop guidance on Audit Committee Reporting.
  16. The evidence to date suggests that the comply or explain approach is increasing the number of retenders and shareholder dialogue on audit matters. However, as a backstop, the ABI would support a mandatory requirement for the Audit Committee to undertake a tender process after 15 years. In the absence of a change in auditor following a retendering after 15 years, a minority of ABI members believe that it may then be appropriate to require a mandatory rotation in the auditor after 20 years. There is no support for mandatory retendering after only five years, which is viewed as extremely onerous and costly.

### **Audit Quality Review**

17. A strong and transparent inspection regime is important. The ABI believes that more frequent audit engagement reviews will ensure increased focus on continuous improvement and audit quality, but it remains unclear how this necessarily translates to increased choice and competition. On the contrary, the proposed requirement for mid-tier firms to be reviewed annually could put them at a relative cost disadvantage to the top tier firms and therefore may become a barrier to entry.
18. There also appears to be an underlying assumption that increased inspections and provision of information on the quality of audit to the Audit Committee will inherently result in the conclusion that a change in auditor is required. However, it can be common for a Company to be limited to a restricted pool of potential auditors due to conflicts of interest or for mid-tier firms not having the sufficient scale or expertise to compete for large cap or specialised audits.

19. In line with the Code's requirement for the Audit Committee to report on how it assessed the effectiveness of the external audit process, it is consistent for there to be disclosure of aspects of the AQR report. However, it is unnecessarily prescriptive to require the disclosure of specific findings and the grade. Given the new requirements of the Code, shareholders would be surprised if an Audit Committee did not disclose how an AQR report had been taken into account in assessing the effectiveness of the audit. Indeed, if it was not disclosed, then that might lead shareholders to question why that was the case and, further, affect their confidence in the ability of the Committee to protect shareholders' interests. As a minimum, shareholders would expect to know when an AQR is undertaken, the key areas of focus and how the Audit Committee is responding to the findings. This has been an active consideration as part of the FRC's Financial Reporting Lab's project to develop guidance on Audit Committee Reporting.
20. Too much disclosure may result in the process becoming adversarial rather than consensual and, in turn, lower the good-willed provision of information and focus on continuous improvement. There is also a risk that the AQR's conclusions are misconstrued as a comment on the quality of financial statements rather than the audit.

#### **Loan agreement provisions**

21. Members support prohibiting loan agreement provisions that restrict a company's choice of auditor to the top four firms. However, while such loan agreement provisions are often explicit, there is also often an implied requirement to use big four firms. Therefore, we would support inclusion of a statement of positive affirmation that no audit firms are precluded from being appointed.

#### **Advisory vote**

22. Members believe that they already have sufficient powers in respect of their oversight of audit matters at Annual General Meetings.
23. Shareholders already vote:
  - a. on the annual report and accounts, which includes the Audit Committee Report;
  - b. on the annual re-election of members of the Audit Committee;
  - c. to approve the external auditor's fees; and
  - d. to approve the appointment of the external auditor.

All these serve to ensure that shareholders have sufficient power to exercise responsible ownership over firms on audit matters. We believe that these powers will take on increased importance as the Corporate Governance Code and ISA700 reporting obligations to improve Audit Committee and Auditor Reporting come into effect.

24. Evidence from the 2012 and 2013 AGM seasons demonstrates that shareholders are adopting an increasingly active approach when voting on the existing audit-related resolutions. ABI analysis shows that there have been an increasing proportion of dissenting votes on audit-related resolutions over the course of the last two years; for example, one company recently nearly failed to achieve majority support for the resolution to approve the auditor's fees<sup>1</sup>.

### **Amendments to Governance Codes**

25. We support consideration of changes to the Corporate Governance and Stewardship Codes to encourage increased engagement on audit and reporting matters. However, this should be considered as part of the normal periodic cycle of review, which will give sufficient time to enable stakeholders to judge the effect of the recent changes. Both Codes should be considered at the same time to ensure that responsibilities between companies and investors remain complementary. We believe the Audit Committee should consult major shareholders on key audit and accounting matters as a form of best practice; for example on the provision of non-audit services and auditor retendering.
26. We believe it is important for shareholders to retain primacy over the agency relationship and avoid the regulator asserting disproportionate influence over the audit process and Audit Committee. As the ultimate clients of the audit, it is important for shareholders to retain an appropriate level of oversight. Such shareholder oversight relies on an appropriate provision of information. Therefore, it is important for companies and shareholders to work together to improve disclosure under the new Code and the international standards on auditing<sup>2</sup> requirements.
27. Shareholder focus on audit and accounting issues has been steadily increasing and the ABI is seeking increasingly to facilitate this among its members. Shareholder engagement in this area is likely to increase in intensity and sophistication over time as Audit Committee and auditor reporting improves and, in turn, equips shareholders with the relevant information to engage in improved dialogue.

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<sup>1</sup> <http://www.investigate.co.uk/pennon-group-plc--pnn-/rns/agm-statement/201308021216078551K/>

<sup>2</sup> [http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-\(UK-and-Ireland\)-700-\(Revised\)-File.pdf](http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-(UK-and-Ireland)-700-(Revised)-File.pdf)

## **Accountability of auditor to Audit Committee**

28. Rather than potentially undermining the role of the Audit Committee by taking decisions away from them, we support empowering their oversight role and access to information. We therefore support strengthening the accountability of the external auditor to the Audit Committee. We do not believe that clarifying the responsibilities of Audit Committees in this way precludes the whole Board from overseeing the final discharge of these obligations. We therefore believe that this proposal would be consistent with the unitary Board concept.
29. Often concern over auditor independence emanates from a perception that executive management controls the terms of the relationship and puts undue pressure on the auditor over key accounting judgements. Particularly in a situation where, for example, the Finance Director, rather than the Audit Committee, leads the tender process and awards non-audit work, there is a risk that the auditor may be seen to become more accountable to management than to the Board of Directors. Shareholders would, therefore, welcome improved transparency over the nature of the Audit Committee's mandate in specific circumstances.
30. In particular, benefit would be derived from clarifying the specific mandate of the Audit Committee beyond its Terms of Reference. As suggested by the recommendation, this should include the scope of the audit work, initiating tenders, recommendations to reappoint the auditor and approving non-audit work.
31. However, we should also welcome clarification of the Audit Committee's interaction with the auditor and Finance Director when new, or changes to, accounting judgements are considered. For example, significant audit and accounting issues, including adverse or unexpected findings or changes in key judgements, should be raised on a timely basis with the Audit Committee so that they can be addressed appropriately, rather than emerge at the final Committee meeting. It is important for the Audit Committee to be given sufficient time and the right information to challenge material accounting judgements. Similarly, the Audit Committee should be kept informed about the development of the control environment and the key risks identified by management and internal audit. It should also be clear that the Audit Committee approves the auditor's engagement strategy for the year.
32. However, different arrangements may be appropriate for different companies. For example, there may be good company-specific reasons why in some circumstances the Audit Committee is happy to delegate certain functions to management, as long as it retains an oversight role that sets the limits of the interaction with the auditor and retains ultimate decision-making powers. Equally, when a new auditor has been appointed, the Audit Committee may wish to adopt a more comprehensive 'belt-and-braces' approach during its period of familiarisation with the company. Therefore, it is unnecessarily prescriptive to require particular restrictions in all circumstances: a more proportionate best practice approach would be favoured. Specifically, we consider the proposed stipulation that only the Audit Committee can negotiate the fees to be unnecessarily prescriptive. It is sufficient for the Audit Committee to approve the fee.

33. ABI members' experience suggests that Audit Committees are already beginning to adopt a more active role in determining the relationship with auditors. This is likely a direct result of the revised Guidance on Audit Committees under the Code. Given that it appears that the revisions are beginning to have the desired effect, we believe this remedy should be incorporated into the suggested review of the Corporate Governance Code, rather than implemented by way of an Order.

#### **FRC objectives**

34. Rather than adopt a specific objective relating to competition, we believe it would be more appropriate for a secondary objective to have due regard to the health and quality of audit markets, which is more consistent with the FRC's focus on the quality of audit.

13<sup>th</sup> August, 2013