

UKCC Statutory Audit Investigation Provisional Remedies: A response from long-term investors

5th September 2013

1. *Introduction*

This document is being submitted on behalf of institutional investors in the UK, responsible for managing approximately £600 bn in assets on behalf of our members and savers, and the UK Shareholders Association, which represents individual investors¹. We all take a long-term approach to our ownership responsibilities, 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 of recent performance.

We have welcomed the UK Competition Commission's (UKCC's) inquiry into the market for large audits, and have all - individually or as a group - participated in the various stages of consultation since the Spring 2012. Like the UKCC, we believe the failures in the audit market are grave, and require fundamental structural changes to ensure stronger accountability of the auditor to their ultimate client, the shareholder. The lack of transparency around the work of auditors, their findings and key considerations / concerns; the opportunities for auditors to undertake non-audit work for executives, whilst at the same time being responsible for checking these same executives; and the excessively long tenures of the audit firms with clients introduce excessive scope for conflicts of interest to emerge, and undermine our ability as shareholders to trust the financial statements. Given the vital role of company accounts in the smooth functioning of financial markets, and the efficient allocation of capital, a robustly independent audit is of the utmost importance.

The UKCC's investigation has been thorough, and we have welcomed the opportunity to contribute. We specifically welcomed the potential remedies published in February 2013, and set out in a joint investor response in March 2013 our views. Specifically, we detailed 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 a proposal that further thought was given to making AQRT reports available to shareholders;
- 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);

We also called for measures to limit non-audit work undertaken by the audit firm, as a key tool for addressing conflicts of interest in the auditor - company relationship.

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

We are writing now to respond to the "Provisional decision on remedies" (22 July 2013). While we welcome several of the proposals to improve transparency and checks in the system, we believe that the proposals do not go far enough. The UKCC has stepped back from tackling the underlying fault-lines in the market that stem from the lack of direct and effective accountability to the shareholder. Our key areas of concern are outlined below. Where we are silent, we are supportive of the UKCC's proposed remedies (including prohibiting restriction on auditor choice in loan agreements; an advisory vote on the sufficiency of Audit Committee reports; and measures to strengthen the Audit Committees control over the audit relationship).

We should stress that this submission builds on our previous contributions in May 2012 and March 2013, and therefore, we do not repeat here our underlying assessment of the problems in the market, or the detailed rationale for our proposed remedies². We focus instead on providing our reactions to the proposals on the table. We would, therefore, encourage you to refer back to earlier explanations where relevant.

It is also worth reiterating that our interest is first and foremost in ensuring we move to a more competitive audit market, which delivers high quality and appropriately priced audits for shareholders. High quality audits must be independent, as well as technically accurate. These are not optional features, but basic requirements.

2. Direct accountability to shareholders is not sufficiently supported by a more active AQRT

The proposals do not go far enough to increase direct accountability to shareholders, and rely excessively on regulatory oversight. Instilling accountability to shareholders depends above all on a robust system for checking the incumbent auditor's work, and the provision of this information to shareholders.

The proposal to increase the frequency and depth of the Audit Quality Review Team (AQRT) investigations in its current form falls down on two counts:

- First, the AQRT is not answerable to shareholders.
- Second, the AQRT will not be required to share its findings on individual companies with shareholders.

² Please see signatory submissions on the issues statement (<http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/statutory-audit-services/evidence/responses-to-issues-statement>) and submissions on the possible remedies (<http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/statutory-audit-services/evidence/responses-to-provisional-findings-report-and-notice-of-possible-remedies>).

Rather than increasing the ability of shareholders to check that their auditors are delivering the scrutiny they require, the proposals would instead award more authority to the FRC. We contend that mandatory rotation offers are far more effective system (see below).

We would, of course, support more frequent and robust checks by the AQRT, will full and frank disclosure to shareholders, where they are undertaken alongside rotation.

3. *Increased risk of regulatory capture*

Some of us have raised in the past our concern over regulatory capture at the FRC, which is an inevitable consequence of its heavy reliance on the audit industry for staff. The proposal to enhance the role of the AQRT will result in even greater staffing demands, and the industry will be the only realistic source of qualified personnel. Consequently, there is a real risk that shareholders are not only excluded from receiving a vital source of information about their auditors (point above), but that the FRC will be at even greater risk of regulatory capture as a result of these proposals.

4. *Competitive tendering without a backstop is not enough*

As we have set out at length in previous submissions, we are of the view that having a cap on the length of tenure for an audit firm with the same client is vital to ensuring independence and shifting accountability to shareholders. There is no better mechanism that we know of for instituting a robust system for "*auditing the auditor*" than ensuring the incumbent's work will be scrutinised by a competitor firm within a time-limited period. This mechanism is also transparently accountable to shareholders. Critically, the results of the check are public. Second, the incoming auditors' incentives are aligned with shareholders because they know that their own work will, in due course, be checked rigorously and be made public too. We note that the European Commission have written to you also asserting the need for a cap on the length of tenure.

A system of competitive tendering without a cap on tenure will naturally favour the incumbent, and Audit Committees will face all the same pressures (as the UKCC documents in detail in its Provisional Findings report) to keep the existing auditor. We do not feel that the proposals put forward genuinely tackle this problem.

As for the question of a cap on tenure artificially restricting competition, we believe that the lack of a mandatory cap on audit tenure will create a far greater barrier to new investments by mid-tier or smaller audit firms to grow and take on larger clients. The risk-reward balance for winning new contracts will remain favourable to incumbent auditors and against the selection of a new audit firm. This is a point that has been repeatedly made to us by mid-tier audit firms, and they have made the same points in evidence to the UKCC.

The term limit for a cap is a matter of judgment. We have proposed 15 years, with an interim tender including the incumbent permitted, to allow sufficient flexibility to the Audit Committee to select the appropriate length for the firm in question.

5. Conclusion

Ensuring a competitive and resilient audit market is of the utmost urgency, not because audit costs are too high, but because the audit system has failed to do its job. Of the UK banks that received taxpayer assistance during the crisis, not one auditor raised concerns prior to approving the accounts. The audit regulator has frequently found problems with audit quality, very often rooted in the lack of willingness of the company's auditors to challenge the executives they have been tasked with checking.

The market for large audit is also excessively - and even dangerously - vulnerable to the failure of one of the large audit firms. There are too few audit firms capable of auditing our largest companies and that means shareholders are left with little choice but to accept arguments against changing auditors to protect independence.

Taken together, the above failures are grave, and require regulatory action. The question is what form that should take.

While we welcome several of the proposals set out in the "*Provisional decision on remedies*" (22nd July 2013), we believe the UKCC has stepped back from tackling pervasive structural flaws in the market. Critically, we believe that increased transparency and accountability to shareholders must lie at the heart of any package of remedies. The proposals do seek to tackle transparency and accountability of the Audit Committee, but the auditors' accountability to shareholders is not adequately addressed.

Our key concerns are:

- Increased reviews by the AQRT on their own will not sufficiently improve shareholders transparency (AQRT company-specific reports will remain confidential) and do not establish accountability to shareholders (the AQRT is not accountable to shareholders, and without access to the reports shareholders cannot hold auditors to account properly).
- Proposals increase the power of the FRC do not address our concerns of regulatory capture;
- Competitive tendering without an outer limit is not sufficient to align auditors' incentives with shareholders.

We remain of the view that the proposals relating to increased Audit Committee transparency and accountability to shareholders are very positive, but should be supplemented by more robust action, including:

- an outer limit on audit firm tenure of 15 years, with an interim competitive tender; and
- a limit of non-audit work that may be undertaken by the auditor.

The UKCC has done an admirable job in setting out the underlying conflicts of interests and structural flaws in the audit market. We would like to see it take proportionate action to tackle these deeply embedded problems. What is proposed, in our view, falls short.

Signatories

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