

# Independent Review into the FRC

## Further questions

### Response from the Investment Association

9 November 2018

## EXECUTIVE SUMMARY

The Investment Association<sup>1</sup> (IA) welcomes the opportunity to respond to Sir John Kingman's letter issued as a part of the independent review into the FRC. The way audits are procured, and audit fees and scope set are of vital interest to investors as users of accounts. In preparing this submission, feedback was sought from the IA's members and also from the members of the Company Reporting and Auditing Group (CRAG) which is the main UK grouping of buy side institutional investors that specifically focuses on accounting and auditing issues.

In managing assets for both retail and institutional investors, the IA's members are major investors in companies whose securities are traded on regulated markets. They have an interest in the requirements governing the preparation and audit of companies' accounts as users. The IA's members rely on the quality and robustness of audits when making investment decisions and holding company management to account. A high quality audit is vital to ensure the markets trust and have confidence in the information companies report.

Set out below are the IA's key observations on the issue raised and in the attached Annex its answers to the detailed questions.

As regards the procurement of auditors, the IA's members support the current construct where the audit committee effectively runs the audit tender process and makes a recommendation to the board. If the board does not accept that recommendation then, in accordance with the UK Corporate Governance Code, the audit committee has to explain why in its report. The investors then ratify the appointment at the AGM. We do not support the appointment being the responsibility of an independent body. This would disenfranchise shareholders and remove directors' responsibilities to shareholders in this respect. A possible consideration would be to give shareholders, prior to a change of auditor, the opportunity to approve the appointment of the new auditor. This would provide a focus for the tender process and oblige the audit committee to set out the process, and why it chose that particular auditor and considered the fee to be at the right level.

On the whole, IA members consider that historically the audit sector has served investors well in that instances of audit failure have been relatively isolated. That said, for investors audit quality is key in that it provides assurance to investors that the accounts can be relied on to provide a true and fair view of performance and ultimately that capital is maintained. However, there are concerns that auditors do not always challenge management sufficiently on their judgements. In particular, a continuing theme in the FRC's AQR reports is a lack of professional scepticism by auditors and challenge to management in relation to key judgements. The AQR notes that auditors sometimes do not challenge management enough and focus too much on gathering and accepting evidence to support management's assertions.

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<sup>1</sup> The IA champions UK investment management, a world leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively they manage £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. Forty per cent of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Audit quality can also be impacted by the limited choice an audited entity can have when it tenders its audit. For example, the incumbent may be time barred and unable to participate in the tender process; others could be precluded as they are providing prohibited non-audit services to the entity; and others could audit competitors of the entity.

It is important that the non Big Four scale up their operations so that they can compete for the audit of large, complex audits. In this context, the audit committee of a FTSE 350 company can be reticent to appoint non Big Four auditor on the basis they do not consider they are credible for the scale and complexity of their business. This can mean that non Big Four firms are reticent to participate in a tender. In addition, the costs of tendering a major audit can be more easily absorbed by a large audit firm and can be a barrier to entry for the non Big Four firms. Investors expect a wide range of firms to be invited to tender and that only the larger multinational groups should have to restrict their choice to the Big Four. In practice this should not involve a significant number of companies.

We trust that the above and attached are self-explanatory but if you require any clarification of the points raised or wish to discuss any issues further then please contact Liz Murrall at [liz.murrall@theia.org](mailto:liz.murrall@theia.org) or on +44 (0) 207 269 4668.

## THE IA@S ANSWERS TO THE QUESTIONS RAISED

### 1. Are the present arrangements sufficiently responsive to the needs of consumers of accounts, particularly in relation to audit quality?

In managing assets for both retail and institutional investors, the IA's members are major investors in companies whose securities are traded on regulated markets. They have an interest in the requirements governing the preparation and audit of companies' accounts as users. The IA's members rely on the quality and robustness of audits when making investment decisions and holding company management to account. High quality audits are vital to ensure the markets trust and have confidence in the information companies report.

As regards the auditor procurement process, the IA's members support the present arrangements where the audit committee effectively runs the audit tender process and makes a recommendation to the board. Whilst the tender process may involve operations and finance functions, oversight by the audit committee is important in the interests of ensuring the tender is managed and directed in the interests of a company's shareholders. It also allows audit committees to consult their major shareholders on the selection criteria, including those that underpin a quality audit.

We consider the audit committee should direct the planning and oversee the process, including identifying candidates, setting the audit quality criteria for selection and conducting the interviews. In this context, the whole committee should be involved in that the tender should not just be the responsibility of the audit committee chair. The audit committee should also ensure there is an RNS announcement when the decision is made. See [IA's Audit Tender Guidelines](#).

If the board does not accept the audit committee's recommendation then, in accordance with the UK Corporate Governance Code, the audit committee has to explain why in its report. The investors then ratify the appointment at the AGM. We do not support the appointment being the responsibility of an independent body. This would disenfranchise shareholders and remove directors' responsibilities to shareholders in this respect.

Investors would, however, welcome more transparency around the procurement process. In 2017 the IA issued Audit Tender Guidelines after consultation with its members. In terms of the audit tender candidates, this clarified that investors would like disclosure of:

- Any restrictions on a firm being able to tender.
- Whether any mid-sized firms will be invited to tender and an explanation where this is not the case.
- How any conflicts between Audit Committee members and tender candidates will be managed and mitigated.
- Whether the incumbent will be invited to re-tender.

Following the tender, the Audit Committee should consider reporting on the following:

- The various stages in the tendering process and the timetable.
- How firms were assessed and the issue of fees addressed.
- Details as to why the firm concerned was chosen.
- A summary of the handover process.

Investors would welcome more transparency around how audit committees assess the quality of the audit and ensured that it was challenging and scepticism was exercised.

In addition, we consider that all too often audit firms consider the audited entity to be their clients. It is a company's shareholders that rely on the auditor's work and to whom the auditor reports. Auditors should consider the investor community to be their true clients and ensure their needs for a quality audit are met. We welcome the fact that some firms are now addressing this. In this context, certain major investors would welcome audit firms discussing the planning process with them so that any significant concerns they have can be addressed.

The real issue for investors is whether there has been a quality audit and investors are concerned that audit quality may be falling. Whilst in the past the FRC's AQR noted that its audit inspection results were improving, this year it indicated that "the Big Four audit practices must act swiftly to reverse the decline in this year's audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council". This is concerning and if it continues would undermine investor confidence in audit which is vital to the effective operation of the capital markets.

The issues that investors consider impact audit quality arise due to a lack of auditor independence and objectivity, as opposed to the procurement process itself, which can result from:

- The incentives that operate.
- The limited number of players and the resilience of the market.
- Non-audit services and the conflicts that result.

Our concerns on these issues were set out in our response to the CMA's Invitation to comment on the Statutory Audit Market.

**2. Notwithstanding the important role played by audit committees, as well as the formal requirement for shareholder approval, can present arrangements risk auditors being too close to company management, and insufficiently incentivised to pose suitable scepticism, objectivity and challenge?**

Whilst in the past auditors appeared to be too close to management in that they were appointed largely by the finance function, the fact that this is now the responsibility of the audit committee has in part addressed this. Nevertheless, a number of investors have concerns. While the best audit committees are very good and genuinely independent, too many are not and do not necessarily use the relationship with the auditor to improve reporting and add challenge to the boardroom. Some also still believe that reducing the audit fee is in the interests of shareholders when the opposite is true.

In addition, whilst it is the responsibility of the board to challenge management's judgments, auditors also have an important role to play and the IA's members are concerned that auditors do not always challenge management sufficiently on their judgements. In particular, over time accounting standards have moved from historic cost to an approach based on fair value which requires more judgement due to the difficulties in valuing and auditing certain assets and liabilities. Professional scepticism is vital when key areas of accounting and disclosure depend on management's judgement.

It is thus a concern that a continuing theme in the FRC's AQR reports is a lack of professional scepticism by auditors and challenge to management in relation to key judgements. The AQR notes that auditors sometimes do not challenge management enough and focus too much on gathering and accepting evidence to support management's assertions. There should be a broader debate on how suitable scepticism, objectivity and challenge is ensured within an audit, this should take place in the context of the wider debate on the future and purpose of audit.

**3. Notwithstanding the FRC's Guidance which states that Audit Committees must be satisfied that "the level of fee payable in respect of the audit services provided is appropriate and that an effective, high quality, audit can be conducted for such a fee", could present arrangements in practice contribute to a situation where audit work is under-priced, under-resourced or cross-subsidised from other work?**

Our members consider it important that the audit committee ensures that in making its recommendation for an auditor's appointment it puts audit quality and not price as its main criterion. Fees should be considered as part of the tender process in that they should be reasonable, i.e. not too low to suggest audit quality could be impaired and not too high as to be excessive. However, they should not be the main deciding factor particularly in the early stages of the tender process. To address this, consideration could be given to requiring companies to conduct audit tenders on a fee blind basis and then, as the fees for the newly appointed auditor tend to reflect what was paid to the former incumbent, justify why the agreed fee is the right one. In this context, over time if the audit firms invest in more and better technology then this should result in a reduction in the cost of audits and associated fees.

Some years ago investors had serious concerns about the pricing of audits in that when auditors tendered an audit they would set the fee low to win the audit and then subsidise the audit with other, more lucrative consulting work. This was a concern for audit quality. These concerns have largely been addressed by the role of the independent directors on the audit committee in the appointment process, and the restrictions on the provision of non-audit services following the EU Audit Directive and Regulation.

Given the importance of a quality audit to the capital markets, IA's members consider it critical that companies prioritise audit quality when selecting an auditor. Investors want the auditor that will provide the highest quality audit appointed and prospective auditors should demonstrate clearly that they can provide a quality service and compete on quality issues. This should help drive innovation in the market place and achieve consistently higher quality audits over time.

**4. Are there any feasible and workable alternative arrangements?**

Investors consider audit quality can be impacted by the limited choice an audited entity can have when it tenders its audit. For example, the incumbent may be time barred and unable to participate in the tender process; others could be precluded as they are providing prohibited non-audit services to the entity; and others could audit competitors of the entity. It is important that the non Big Four scale up their operations so that they can compete for the audit of large, complex audits. In this context, the audit committee of a FTSE 350 company can be reticent to appoint non Big Four auditor on the basis they do not consider

they are credible for the scale and complexity of their business. This can mean that non Big Four firms are reticent to participate in a tender. In addition, the costs of tendering a major audit can be more easily absorbed by a large audit firm and can be a barrier to entry for the non Big Four firms. Investors expect a wide range of firms to be invited to tender and that only the larger multinational groups should have to restrict their choice to the Big Four.

A market share cap has been suggested as a way of helping open the UK statutory audit market to other entrants. This is supported by some investors in that it would set a limit on the proportion of large companies and PIEs that the Big Four could audit and be a direct way to increase the number of audit firms in the market. It would also be preferable to a forced break-up of the Big Four, which would take a long time, be fraught with legal difficulties and be an issue if the UK splits firms whilst the global networks remain unified.

However, others have reservations about how this would play out in practice. For example, say a cap was imposed of 20% of the audit market for any one auditor. The Big Four would thus take 80% and it is likely that the remaining 20% is particularly risky, costly in terms of geographic distribution, complex and has reputational issues.

#### **5. If some auditors of some or all major companies of public interest were to be appointed in a different way, by whom could this be done in practice?**

The IA's members do not support the introduction of an independent body such as the London Stock Exchange to appoint auditors to FTSE 350 companies. They support the current construct where the audit committee effectively runs the audit tender process and makes a recommendation to the board. If the board does not accept that recommendation then, in accordance with the UK Corporate Governance Code, the audit committee has to explain why in its report. The investors then ratify the appointment at the AGM.

To put the appointment in the hands of an independent body would disenfranchise shareholders and remove directors' responsibilities to shareholders in this respect. It also goes against requirements that have recently strengthened the role of audit committees. Moreover, it would be difficult for an independent third party to have the appropriate knowledge of the business to evaluate the quality of an audit tender and, therefore, we do not believe that such an arrangement would be practical or lead to an increase in audit quality.

Whilst Public Sector Appointments Limited appoints auditors to local public bodies, including councils, police and crime commissioners, and fire and rescue authorities, such bodies do not have external shareholders.

A challenge for investors in the approval of the auditor is that a vote against the incumbent at the AGM can be disruptive. However, given the need to 'cleanse' new auditors of threats to independence, such as the provision of non-audit services, many tenders are completed significantly before the new auditor takes office. In addition to the vote to reappoint the incumbent at the AGM, prior to a change of auditor consideration could be given to giving shareholders the opportunity to approve the appointment of the new provider. This would provide a focus for the tender process and oblige the audit committee to set out the process, and why it chose that particular auditor and considered the fee to be at the right level. This vote to approve the new auditor would be a significant new power for

shareholders at a time when there was more scope for influence, and ought to add an important new tension and dynamic to the auditor appointment process.

- 6. What capability would need to be built up to do this competently? How could this be properly governed?**
- 7. How could this be done in a way which commanded the confidence of users of accounts, such as investors? How could investors' rights of approval over auditor appointments be protected in any new arrangement?**
- 8. How would any alternative body take into account the views of Audit Committees?**
- 9. What companies should any new arrangement apply to? Is there a case for piloting an alternative approach, for instance in relation to cases where deficiencies in audit have been identified?**

See Q5. That said, certain investors consider there may be a case for exploring the possibility of an external body mandating a change in auditor in circumstances where audit quality is very poor and where the audit committee has failed in its duty to address this, say by tendering the audit. They envisage that such a power would only be used in exceptional circumstances but its existence could help ensure deficiencies are addressed.