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Dear Sir/Madam

Statutory Audit Services Market Investigation – Notice of possible remedies under Rule 11 of the Competition Commission Rules and Procedure

I would like to thank the Competition Commission for taking the opportunity to meet with Legal & General Investment Management (LGIM) on the 4th May 2012. As you are aware, we are one of the leading fund management groups in the UK managing approximately over £406 billion of assets for more than 3000 clients (as at 31st December 2012).

I am writing this letter to you in response to your consultation on possible remedies for the Statutory Audit Services Market to promote competition. LGIM welcomes the opportunity to respond to this review and is fully supportive of its main aims and objectives.

As the Competition Commission (CC) has highlighted,

"competition in the audit market is restricted by factors which inhibit companies from switching auditors and by the tendency for auditors on satisfying management rather than shareholder needs."

In addition,

"it is important to note that auditors are appointed to protect the interests of shareholders, who are therefore the primary customers, and too often auditors focus is on meeting the needs of senior management who are key decisions takers on whether to retain their services. This means that competition focuses on factors that are not aligned with shareholder demand."

We have seen this with the companies in which we invest in on behalf of our clients and it is for this reason that we believe there is scope for improvements in the audit market.

We take the view that the proposed remedies highlighted in the consultation are a welcome step to realigning the accountability of auditors to shareholders. Furthermore, specific proposals such as mandatory rotation, prohibition of 'Big 4 only' clauses, strengthen the accountability of external auditors to the Audit Committee and enhanced reporting requirements are all features which will promote and improve the efficiency of the audit market.

We would also like to draw your attention to a letter we co-signed with USS and over 30 other institutional investors on the 22nd February 2012 managing approximately £1.8 trillion. These reforms reflect the perspectives of long term shareholders.

We have provided a response to each of the remedies proposed by the CC and hope we can contribute effectively to your review.

Please do not hesitate to contact me directly if there is anything you would like to discuss in detail.

Yours sincerely,

Sacha Sadan
Director of Corporate Governance

RESPONSE TO CONSULTATION

Remedy 1 – Mandatory tendering

We support the CC proposal requiring companies to mandatory put the external audit contract out to tender. In our submission to the FRC on Revisions to the UK Corporate Governance Code and Guidance on Audit Committees dated 31st July 2012, we suggested an initial period of 10 years, with 5 years to prepare and appoint a new external auditor.

We understand that rotation between partners within the same auditor firm often occurs in practice. It should be up to the company to decide the frequency of tendering whether it will be 5 or 7 years. However, even after the tender process has occurred, we would still expect a complete change of auditor after a full 15 year term is served which acts as a back-stop.

The reason for this is assuming that a company has a policy of tendering audit every 5 years and has decided to retain its current auditor firm for 3 terms (i.e. same firm for 15 years), the risk of the auditor losing its independence is greater and we would expect "a new fresh of eyes" to conduct the audit.

We agree with the CC proposals that tendering should be conducted on an 'open book' basis. This will also give the Audit Committee more information to better judge the quality of audit the firm competing for the contract may provide and make better judgements on negotiating fees.

Remedy 2 – Mandatory rotation of audit firm

As highlighted above, we believe that there should be mandatory rotation of a firm every 15 years in order to preserve the independence and integrity of audit activity for shareholders.

By making it mandatory to have maximum audit tenure, this will encourage rotation amongst the audit firms, increase competition and shift accountability. Furthermore, due to the concentration of the audit market, companies should have a contingency plan to appoint a replacement audit firm should one suffer significant damage or loss in confidence which has happened in the past. Therefore, firm tenure, which has been a factor in misaligning incentives, will be eliminated if mandatory rotation is implemented.

We acknowledge that this remedy is linked with the first remedy of mandatory tendering. In addition, although the CC has highlighted 7, 10 and 14 years as time frames for rotation, we believe 15 years is a more realistic and flexible period for companies.

In relation to circumstances whereby there may be instances the choice of audit firm is constrained making it impractical to switch auditor at that time, we agree that there may be a mechanism whereby the FRC grants relief from this requirement. However, this should only be on exceptional grounds and shareholders would expect a full explanation disclosed in the Report & Accounts. In addition, the company should state when they would expect to return to normal practice of rotation.

Remedy 3 – Expand remit and/or frequency of Audit Quality Review Team (AQRT)

We acknowledge the role of the AQRT at the FRC as a check on the quality in the audit market. However, we believe that there are limitations to this process and would be supportive of a self-regulatory audit market (such as an mandatory audit firm cap) in order to support the role of the AQRT.

In addition, with regards to reporting, we would like to see reports from the AQRT on company specific cases rather than on the auditor firms themselves. This will help

shareholders understand better the audit process within the companies in which we invest in and provide a basis for engagement and holding Audit Committees to account.

Remedy 4: Prohibition of 'Big 4 only' clauses in loan documentation

We support this remedy because it removes a barrier to entry for non-Big 4 audit firms and, in combination with the other proposals, promote competition.

Remedy 5 – Strengthened accountability of the External Auditor to the Audit Committee (AC)

We support the rationale behind this proposal to improve the accountability of the external auditor to the Audit Committee. We believe that the Audit Committee, which is constituted of independent Non-Executive Directors, play an important part in protecting shareholders and overseeing the whole audit process.

We acknowledge that there is a risk that management may influence the information that is provided to the Audit Committee and therefore be bias and not reflect the true underlying picture of the health of the company. Therefore, it is important that auditors and the Audit Committee communicate directly if there are any issues that need to be raised and that the information provided to the Audit Committee is timely and relevant. This will help with judgements relating to firm/partner selection, fee negotiations and decision-making.

Although management still have a responsibility on audit activity, we believe it is important for auditors to have this direct communication channel to an independent source in order to manage conflicts of interest and to protect shareholders.

Remedy 6 – Enhanced shareholder-auditor engagement

We welcome this remedy by the CC to improve the process by which auditors are accountable to shareholders.

In particular, we support the proposal by the CC to require a supermajority vote on the reappointment of the audit firm if that auditor was still in place after a mandatory tender. We note that an adverse vote against an auditor is very rare in the UK market. However, requiring a 75% approval vote by shareholders will increase the accountability of the company to provide comfort to investors that the tender and rotation process undertaken was rigorous and thorough.

Furthermore, with regards to the requirement that the auditor is to be present at the AGM and to have a dedicated Q&A session on the agenda is also a welcome step to improving accountability to investors. We believe this proposal provides the necessary forum in which shareholders can engage with auditors on any concerns. It should be noted though we would not like this to diminish communication with the Audit Committee, but rather compliment and enhance the engagement in order to better understand the audit process.

Remedy 7 – Extended reporting requirements

Although we support any proposals that will provide more transparency and disclosure of information relating to the audit process, it is important that any extension to reporting requirements is meaningful. We would not like to see more boilerplate language added to reporting as this will devalue the purpose of reporting and become a barrier to judging audit quality.

We believe that the disclosure on the audit process should give investors a real insight in to how decisions are made and the level of communication between management, the Audit

Committee and the external auditors. This should also highlight any key risks, how this relates to the business model and strategy, and whether there are any considerations taken to improve performance going forward.

We support the inquiries by the FRC and International Auditing and Assurance Standards Boards on how audit reports and financial statements can be enhanced to increase their value to shareholders. We will be submitting our views in due course.

Other related issues

Non-audit fees

Although we acknowledge the explanations provided by the CC on non-audit fees, we believe that there is still a risk that such services could impair the independence of audit. Such services like consultancy work may start of on a small scale but develop to a larger amount. This can possibly add to the retention of the incumbent audit firm and reduce the bargaining power of companies to change their auditors. Therefore, we would like the CC to revisit this issue.

In particular, although we understand that audit work is more standardised, depending on the company itself, it is still possible that non-audit work could be on a large scale and vastly exceed audit work. This in itself poses a risk to auditor independence and integrity. As shareholders, we have seen non-audit fees as a percentage increase in size.

For example, with Arthur Andersen, the audit firm failed to maintain its authenticity in conducting audits for their clients, whilst trying to expand their consultancy service offerings and maximise profits. This catastrophically led to damage in reputation, loss in confidence and the collapse of one of the biggest audit firms in the world which was once one of the “Big 5”.

We believe that a 50% upper threshold limit for non-audit fees to audit fees should be implemented. By limiting the work that is done by the auditor, we believe this mitigates this risk and the conflict of interest. Audit is at least twice as important as non-audit work.

Furthermore, we note in the UK Corporate Governance Code C.3.8 that “if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded”. We support this statement and would expect a company that utilises the same firm to do its audit and carry out non-audit services to provide a breakdown of the fees and rationale behind their appointment to carry out this role. This will also enable us as shareholders to be better informed on how we should exercise our voting rights at the AGM in relation to the reappointment of auditors.