Statutory audit market study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London, WC1B 4AD

30 October 2018

USS Investment Management's Response to the Invitation to comment on the Statutory audit market study

Dear Sir/Madam,

We welcome the CMA undertaking this review of the statutory audit market and being given the opportunity to respond.

By way of background, Universities Superannuation Scheme (USS or the scheme) is one of the largest pension schemes in the UK, with total fund assets of over £60 billion. The scheme's trustee is Universities Superannuation Scheme Ltd (USSL), a corporate trustee which provides scheme management and trusteeship. USS Investment Management, a wholly-owned subsidiary of Universities Superannuation Scheme Ltd, is the principal investment manager and advisor to USSL. As an institutional investor that takes its fiduciary obligations seriously, USS aims to be an engaged and responsible steward of the companies and assets in which we invest (including both listed companies and direct investments such as Moto, NATS, Heathrow and Thames Water) and through the asset management services we procure.

We are therefore able to respond to this study from three perspectives: as an investor using listed company accounts to make investment decisions, serving ourselves or having appointed an independent director on the audit committee of six of our direct assets, and as a firm whose accounts are audited.

As investors, we rely on high quality, independent audits to help ensure that the companies in which we invest give a true and fair view of their performance and capital allocation decisions. Through the exercise of our voting rights and our engagement activities, we hold the boards of the companies we invest in to account. We expect (i) the audit to be tendered on a regular basis, (ii) that the auditor is changed at least every 20 years, and (iii) that a clear breakdown of auditor's fees is disclosed. In 2017, we voted against the re-election of the external auditors at 17% of the general meetings of our UK listed equity portfolio, where the above standards were not met. The most common reason for voting

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against was the extended tenure of the incumbent external auditor. In a few cases, the external auditors also provided remuneration advice to the Remuneration Committee.

Low competition in the audit market could result in two undesirable outcomes: higher priced audits and/or low quality audits. As both an investor and preparer of accounts, audit quality is our highest priority and any proposed remedies should not be detrimental to audit quality.

Whilst we can see the advantages of some of the solutions suggested by the CMA, such as joint audits, based on our own experience of being audited, we believe that the ring-fencing of audit activities within the firms (Question 16 and 18) might harm the quality of audits in the short term. This is mainly because audit firms may not be able to access their specialist non-audit staff expertise, for example as related to tax matters.

We have highlighted below our key points on the statutory market study:

1. Consultation Question 2: How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?

The audit framework is overall appropriate but should be more risk-based and look to better leverage data analytics.

Overall, we believe the sector is serving its stakeholders well as instances of audit failures are the exception. However, we believe that audit quality can be improved by ensuring a more widespread adoption of a risk-based approach. While this has already been endorsed by the FRC, our discussions with our investee companies suggest this is less common than we would like.

This point also reflects our own experience of being audited. The amount of time spent by senior members of the audit team with the client understanding critical risks is one of the key determinants of service quality offered to management and the audit committee. Together with a deeper understanding of the risks by the auditors, the audit can also be made more efficient by using technological advances such as data analytics to reduce the amount of audit time spent on substantive testing of low materiality items. However, it is not apparent that this is making as much progress as it could. Our experience leads us to conclude that there is still an emphasis on substantive testing of these items rather than focussing on more meaningful parts of the audit. We believe that more time with senior experienced auditors who are able to provide a critical and insightful eye over processes/controls, as well as having a thorough understanding of the audited company (and its operations) would improve the overall quality of the audit, by providing greater insights and recommendations for improvement.

2. Consultation Question 3: To what extent do the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?

Increased attention has been given to audit tendering, but audit committees could increase their oversight of the internal and external audit plans.

It is essential to take a holistic view when considering the quality of audits, as this is influenced by the effectiveness of the audit committee, management's responsiveness to auditors' recommendations, and external auditors' own coordination with the internal audit function.

The audit committee plays a crucial role in ensuring the management team implements the external auditors' recommendations (letters to management). The audit committee should also ensure that

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investigations are risk-based and that the external and internal auditors are coordinated. The Auditing Standards published by the FRC recommend that the external auditor discusses significant risks as well as how they and internal auditors can work together in a constructive and complementary manner with the audit committee. In our experience, this is not always put into practice.

It is important that audit committees also make suggestions where it appears that there is "over-auditing" (or where the audit work is not as risk based as it could be). Audit committees should challenge additional disclosures where such disclosures are not related to material items. Audit firms should be required to share the planned and actual breakdown of hours spent by grade on the audit, and the dates when the planning and final files were signed off by the partner.

3. Consultation Question 9: In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?

There is limited choice for switching in practice.

We are supportive of the auditor independence rules for non-audit services. However, this limits our choice of auditor from an already limited pool. This limitation on choice has an impact on how competitive the market is. As an example, in recent years, we appointed a non-Big Four auditor but reverted to a Big Four firm in 2017 following a competitive tender led by the audit committee. Unfortunately, only two firms tendered – the incumbent and one Big Four. As a substantial user of services from the Big Four outside of the external audit area, it appears that conflicts over the potential loss of non-audit fee income compromises the competitive nature of audit tenders for organisations such as ourselves.

4. Consultation Question 23 Could a joint audit be an effective means of implementing a market share cap?

The joint audit option could be explored.

In France and North Africa, the financial statements are divided between two auditors. Whilst this indeed distributes market share more evenly, it is unclear whether it improves audit quality as sections of the financial statements are split between the auditors and they do not seem to review the sections audited by the other firm. In addition, the two auditors' methodologies and materiality threshold can vary. However, if mid-tier firms were encouraged to participate, this solution could leverage the skills and capabilities of each firm, allowing mid-tier firms to be exposed to the technologies used by the Big 4. In addition if the allocation of sections is changed every two or three years it would ensure the audit work is reviewed on a more regular basis. We would assume that peer reviewing improves quality if there is accountability at the end.

5. Consultation Question 24 and 25 Should the auditors and those that manage them be accountable to a wider range of stakeholders, and if yes, should audit committees be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?

The accountability of the board and the audit committee to shareholders should not be diluted, but disclosure could improve further to satisfy other stakeholders.

As investors, we would prefer that the audit committee and the board remain accountable for making recommendations about the auditors to shareholders. Indeed, active investors such as USS have the

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ability to hold audit committees and boards to account for their recommendations at the annual general meeting by voting against the re-election of the auditor or against members of the audit committee. It is unclear how the wider stakeholder base would, in practice, be able to hold audit committees to account.

The suggestion to replace audit committees by an independent body would dilute this accountability even further as shareholders, or the wider stakeholder base, would not be able to protest or vote against this body at general meetings. We would also like to emphasise that we would not favour any UK-only remedies such as this that might impair our ability as a global investor to encourage globally consistent governance practices.

Overall, disclosure has improved with the introduction of extended audit reports, which benefit both direct shareholders and a wider stakeholder audience. However, it would be useful to have more clarity on whether there were concerns in the process and on the scope of the audit (particularly any areas that were not audited or were subject to a more restricted audit process).

We look forward to further clarification on the above in the CMA response and would welcome further engagement on this topic.

Yours faithfully,

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