PENSIONS AND LIFETIME SAVINGS ASSOCIATION

5 November 2018

Mr Will Hayter
Project Director
Statutory Audit Market Investigation
Competition and Markets Authority
Victoria House
Southampton Row
London WC1B 4AD

Dear Mr Hayter,

PLSA RESPONSE: CMA STATUTORY AUDIT MARKET – INVITATION TO COMMENT

The Pensions and Lifetime Savings Association brings together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses, including asset managers, investment consultants and other service providers. Our mission is to help everyone achieve a better income in retirement.

Introduction

We welcome the opportunity to feed in to the Competition and Market Authority (CMA)'s Invitation to Comment on the Statutory Audit Market. The PLSA has an interest in ensuring that the audit market serves the needs of our pension fund members as investors in UK companies both directly and indirectly through equity and bond holdings. A high-quality audit is of vital importance to investors in making assessments and investment decisions.

DB pension schemes have an additional interest in a well-functioning statutory audit market. In an era where many DB schemes are facing significant underfunding challenges, many of these have relied upon high levels of Deficit Repair Contributions (DRCs) from the sponsoring employer to solve the funding gap. The precise level of DRCs will often be the result of active dialogue between the DB trustees and the sponsoring employers and to support these discussions, trustees need to be able to trust that the financial statements of their sponsoring employers are a true and fair representation of the company's financial health.

Although we think that the audit sector is serving its stakeholders, we support further measures to strengthen independence and improve competition in the market, provided that the competition is with regard to audit quality rather than price. It is in the interests of all the underlying consumers of audit services that we continue to improve and safeguard audit quality. At this stage, our response takes a high-level approach. We also refrain from commenting in detail on specific remedies at this early stage of the study. We look forward to further discussion with the CMA on this issue, including at the forthcoming roundtable with our pension scheme members later this month.

The state of the audit market

It is vital that investors are able to rely upon the financial statements of potential investee companies for their assessments and investment decisions. It is also important that other stakeholders, such as trustees of a firm's Defined Benefit (DB) scheme, can trust in the quality of audited statements and financial reporting.

There are many audits in the UK which are of good quality, however high profile failures or even the perception of failure can be extremely damaging to investor (and public) confidence. Where there is aggressive accounting by management and errors on boards of directors, auditors must have the necessary professional scepticism to challenge such practices.

However, as the Invitation to Comment points out, the 'Big Four' firms dominate the audit of companies in the FTSE 350 – not just the very largest companies – and this does not necessarily indicate a well-functioning market in terms of choice[1]. While some of the largest companies are so multinational that they do require the global networks enjoyed by the Big 4, even among the FTSE 100 there are businesses which are active in relatively few markets and so do not require the spread that those largest firms offer. It is notable that when Arthur Andersen ceased to exist, the Big Five became the Big Four instead of creating the opportunity for a medium-sized firm with the opportunity to grow in scale to join these ranks. We feel that were another firm to exit the market, there would be a risk that the Big Four would become the Big Three instead, which would further reduce competition and choice – particularly for large multinationals.[2]

We look forward to further analysis from the CMA regarding the extent to which switching has taken place, particularly in the wake of new legislation and remedies regarding tendering of statutory audit engagement and mandatory auditor rotation. We believe that long-standing relationships between auditors and management can work to inhibit the dispassionate approach required for a high quality audit.

We are also concerned that Audit Quality Reviews undertaken by the Financial Reporting Council (FRC) demonstrate an ongoing theme in terms of a lack of professional scepticism.

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[1] It is worthwhile highlighting any here that any remedies proposed should aim at ensuring a market where firms can compete on quality and that some of our scheme members have expressed views that the Big Four's dominance may in part owe to the overall quality of audits and the talent and knowledge large firms are able to attract in what is a knowledge industry.

[2] It is also worthwhile noting that in practice, the choice for large multinational firms may be even smaller; for instance, if you are a large company with a pension scheme which wishes to keep the corporate auditors and pension scheme auditors as separate providers, and who may both have recently changed auditors, your options to go elsewhere outside these four firms for audit or consultancy work are limited.

In terms of barriers to entry in the market, we believe a key challenge is the high cost of tendering for the audit of a large firm. This cost is harder for smaller firms to absorb and we note Grant Thornton's announcement that it will no longer compete for FTSE 350, though we suspect that the firms would be more willing to bear the cost of tendering if they perceived there to be a realistic chance of winning the audit business.

The role of the audit committee

We have welcomed previous work to strengthen the oversight, governance and transparency of audit committees. Clarifying the scope and role of the audit committee in initiating tenders, recommending appointments to the Board and approving any non-audit work, as well as ensuring committees are properly accountable to investors has the potential to ensure that executive management's relationship with the auditor is conducted at the appropriate distance. However, we believe more could be done.

We understand that some audit committees place emphasis on how successful they have been in negotiating down audit fees. Although cost is certainly one factor to consider when assessing potential audit firms, investors – the main stakeholder focus of any financial report – would prefer the emphasis to be very clearly on the role of the (likely) quality of the audit, even if this costs more.

Although we agree that it is important that an audit committee has the appropriate expertise in audit and accountancy practices to be able to fulfil its role effectively, we believe that there should steps taken to ensure a balance of expertise on the committee. In particular, we think there is a case for ensuring greater investor representation on audit committees. This should help committees assess their auditors with a clear eye as to what investors are looking for and could also help counteract any perceived lack of independence.

We note that not all audit committees have welcomed innovation in terms of audit quality. We understand that KPMG offered all of its audited companies a public audit report that included a graduated view on the conservatism of the accounting in the key areas of judgement (such as was first published on the Rolls Royce accounts) but that few showed any appetite to permit such additional disclosures. The underlying consumers of the audit, the shareholders, would have strongly welcomed this being done across the piece (by all audit firms) and we remain disappointed that this has still to be delivered.

The role and function of the FRC

In our response to The Kingman Review of the FRC, we noted that members have consistently expressed concerns about the lack of transparency of the FRC's investigative processes and procedures, including its Audit Quality Reviews (AQRs). The FRC undertakes important investigative work which is vital to ensuring the quality of audits remains consistently high and we believe that greater transparency around its approach would be helpful in providing further guidance to its stakeholders – both audit firms and investors – regarding what is considered good and poor practice. This could include publishing the outcome of individual firms' AQRs.

We have also previously expressed concerns about the relative imbalance of backgrounds of the FRC's staff, with what seems to be a significant and dominant proportion drawn from the accountancy and audit professions, as opposed to those with investor practitioner expertise and experience. While this may make sense given the balance of the FRC's powers regarding audit/accountancy and corporate governance/stewardship, we think that greater representation of the investor viewpoint at every level of the FRC and in every team would help not only the FRC's stewardship work but also its work on audit issues.

We hope that the above has been helpful. If you would like any further information or clarification, please do contact us.

Yours sincerely,

Caroline Escott
Policy Lead: Investment and Stewardship

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