

## Statutory Audit Market

### AIC's response to the Competition and Markets Authority

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the invitation to comment on the Statutory Audit Market by the Competition and Markets Authority.

The Association of Investment Companies (AIC) is a trade body for the closed-ended investment company sector. We represent 351 investment companies, managing assets of over £146 billion. The AIC's members are predominantly listed on the Main Market of the London Stock Exchange. Some have shares admitted to trading on the Specialist Fund Segment; others are quoted on AIM.

The AIC's members include investment trusts, Venture Capital Trusts, UK REITs and non-EU companies. Our non-EU members are primarily domiciled in Guernsey and Jersey.

Closed-ended investment companies are collective vehicles which pool their shareholders' capital and hold a portfolio of assets to spread risk and generate an investment return. Investments include listed securities, private equity, debt, property and infrastructure.

Investment companies have some unique features as a result of their structure. Investment companies:

- have independent boards comprised of non-executive directors with legal obligations to look after shareholder interests. They often do not have executive directors or employees as most investment companies appoint an external investment manager and outsource other services;
- are owned by shareholders and returns accrued from the underlying portfolio are paid out as a dividend or contribute towards the capital growth of the company.

### ***Question 14 - Restrictions on audit firms providing non-audit services.***

One of the suggestions set out in section 4 is to restrict audit firms providing non-audit services. The Statutory Audit Amending Directive and Regulation (SAADR) already prohibit the statutory auditor from providing certain non-audit services to an audited entity which is a Public Interest Entity (PIE). Additionally, any permitted non-audit services must not exceed 70% of the average of the fees paid in the last three consecutive years for the audit.

Assessing which services the auditor should provide and who should provide them is the responsibility of the audit committee which makes recommendations to the board. Further restrictions would reduce the ability of the audit committee to act in the best interest of the company.

The choice available to audit committees to select service providers to provide audit and non-audit services must remain as extensive as possible. To introduce any restrictions that go beyond those outlined in the SAADR may reduce the number of audit firms willing or able to

tender for particular audit or non-audit work and therefore would serve to restrict further the choice of provider available to companies.

For our member companies that comply with the AIC Corporate Governance Code (as endorsed by the FRC), and for those companies complying with the UK Code, the audit committee is responsible for *“developing and implementing a policy on the engagement of the external auditor to supply non-audit services, ensuring there is prior approval of non-audit services, considering the impact this may have on independence, taking into account the relevant regulations and ethical guidance in this regard, and reporting to the board on any improvement or action required.”*<sup>1</sup>

If the external auditor provides non-audit services, the audit committee must also provide an explanation of how auditor objectivity and independence are safeguarded. Therefore, there is a clear explanation in the accounts with regard to the provision of non-audit services. The requirement for listed entities to disclose details of audit and non-audit fees in the annual accounts provides the investor with relevant information.

The AIC **recommends** that no further restrictions are placed audit firms to limit their provision of non-audit services.

### **Question 14 – Break the link between company management and auditor**

Another suggestion in section 4 is to break the link between the company management and the auditor. Most investment companies are externally managed, i.e. their boards are comprised of non-executive directors and they outsource the day-to-day activities of the company.

The non-executive directors have legal duties to act in the best interest of shareholders. Additionally, for those companies that must comply with the FCA’s Disclosure Guidance and Transparency Rules, the audit committee must:

- comprise of a majority of members who are independent;
- have at least one member who has competence in accounting or auditing, or both; and
- have competence relevant to the sector in which the entity is operating.

These rules place a significant onus on the committee members to act independently and to have certain competencies.

Were the power to appoint an auditor and manage their performance given to shareholders directly, or shareholders indirectly through shareholder groups, or other independent institutions or bodies such as a sector regulator or stock exchange, it is likely that other unintended problems would arise.

For example, audit committees have valuable knowledge about the company, its strategy and operations. This is important when appointing and assessing the performance of the auditor.

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<sup>1</sup> The UK Corporate Governance Code July 2018, provision 25

The directors are better positioned to challenge the auditor about certain findings or to direct the auditors to review particular areas where they may have concerns.

The importance of understanding the business is also supported by the “*International Standard on Auditing (UK) 315 – Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment*”. This recognises the need for the auditor to obtain an understanding of:

- the relevant industry;
- the nature of the entity, including its operations, ownership and governance structures, types of investment it is planning to make, and the way that it is structured and how it is financed;
- the entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement;
- the measurement and review of the entity’s financial performance;
- the entity’s internal controls.

Introducing a third party into the process of appointing or reviewing the performance of the auditor will risk other issues arising as they will not have the requisite detailed knowledge or understanding of the business.

The AIC **recommends** the audit committee continues to be responsible for selecting the auditor and making a recommendation to the board, and assessing the performance of the auditor.

***Question 24 – Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?***

For companies that report against the UK Corporate Governance Code (the Code), the 2018 Code places a greater onus on companies to engage, not only with their shareholders, but also with the wider stakeholder community.

Additionally, the Companies (Miscellaneous Reporting) Regulations 2018 include the requirement for public companies to have a statement in their strategic report explaining “*how the directors have had regard to the matters in section 172(1)(a) to (f) when performing their duty under section 172*” of the Companies Act 2006.

The AIC **recommends** that the 2018 Code and these regulations be given time to be embedded before any further changes are considered about who the audit committee is accountable to.

***Question 27 – Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?***

The SAADR applied from 17 June 2016. The rules require PIEs to rotate their audit firms after a period of maximum tenure. Broadly, in the UK, (subject to transitional arrangements) PIEs must retender their audit engagement at least every 10 years, with no auditor being able to hold office for more than 20 years.

The AIC **recommends** that these new requirements be allowed to bed in before further changes are considered in relation to audit rotation.

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**To discuss the issues raised in this paper please contact:**

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