Statutory Audit Services Market Study

AIC's response

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the update paper on the Statutory Audit Services Market Study published by the Competition and Markets Authority (CMA).

The Association of Investment Companies (AIC) is a trade body for the closed-ended investment company sector. We represent 355 investment companies, managing assets of over £165 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 typically:

- Are operationally very simple, with limited or no physical presence.
- Have independent boards comprised of non-executive directors. The substantial majority do not have executive directors or employees and therefore do not have internal audit functions. Instead, they outsource the day-to-day running of the company to third party services providers;
- Do not provide goods or services, have no trading activity or customers. They are investment vehicles for their shareholders, but do not provide services to those shareholders;
- Have no externalities, so are not within scope of regulations such as the Modern Slavery Act 2015 or the Energy Savings Opportunity Scheme Regulations because they have no turnover; and
- their suppliers are typically professional advisers or regulated firms.

The audits of investment companies are relatively simple when compared to that of a trading company and the audit fees are typically much lower.

The AIC is not aware of any concerns raised by investors about the quality of the audit for investment companies.

Question 2a – Do you agree with our analysis of the issues that are driving quality concerns… in particular: a) issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors.

As outlined above, the majority of investment companies have independent boards comprised of non-executive directors. The day-to-day operations of the company are outsourced to external providers such as the fund manager and the administrator. Therefore, there are no executive directors or employees.

The CMA paper states that "*the Audit Committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.*" It identifies that in some entities there is "*an excessive involvement of companies' CFOs and top management in the conduct of the tender process*". It also states that "*it is crucially important that auditors provide appropriate independent challenge and are willing to take tough judgements, sometimes in the face of strong pressure from a company's management*". The AIC agrees with all these statements.

Investment companies subject to the Chapter 15 Listing Rules are required to have a board of directors who "*must be able to act independently*" of the investment manager.

It is important that any remedies are applied proportionally and take into account the unique structure of investment companies which do not have employees, senior management, or executive directors. Therefore, audit committees of investment companies will have significantly less day to day involvement with the auditor and the "*cultural fit*" bias identified by the report poses less of a risk in the tender process.

Question 3 – What should the scope of each remedy be? Please explain your reasoning.

Please refer to our response to question 5 below.

Question 4 – How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

The AIC does not agree that there needs to be any additional scrutiny of audit committees, specifically in the investment company sector.

If proposals are brought forward to regulate the scrutiny of the audit committee, the AIC **recommends** these specifically exclude investment companies. Investment companies that should be excluded are:

- Companies listed on the London Stock Exchange under Chapter 15 "Closed-Ended Investment Funds: Premium Listing";
- Companies listed on the Specialist Funds Segment of the London Stock Exchange; and
- Investing companies quoted on AIM.

If investment companies are not all excluded, then the AIC **recommends** that any proposals only apply to those in the FTSE 350.

The aims of the remedy as stated in the paper are to "*ensure that Audit Committees fully protect the interests of shareholder when making decisions about the auditor selection and monitoring the audit engagement. In turn, this remedy will improve incentives for high-quality audits. This remedy would also ensure that challenger firms are not unfairly disadvantaged due to biases during audit selection procedures.*"

Non-executive directors already 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.

In addition, for our member companies that report against the AIC Corporate Governance Code (as endorsed by the FRC), or directly against the UK Code, there are a number of recommendations which apply to the board and the audit committee. These state:

- "*The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of … external audit functions and satisfy itself on the integrity of financial and narrative statements.*" (Principle M)
- "*The main roles and responsibilities of the audit committee should include: …*
    - *conducting the tender process and making recommendations to the board about the appointment, reappointment and removal of the external auditor, and approving the remuneration and terms of engagement of the external auditor;*
    - *reviewing and monitoring the external auditor's independence and objectivity…*" (Provision 25)

The legal duties, coupled with the UK Code provisions, clearly set out the standards directors should adhere to protect the interests of shareholders when dealing with the external auditor.

Applying any additional rules on audit committees for investment companies would not be proportionate. The AIC considers that there are already sufficient legal and regulatory requirements to ensure the proper conduct of audit committee members for investment companies. The structure of investment companies is very different to trading companies (see our introductory comments on page 1). Also, audit committees of investment companies have significantly less day to day involvement with the auditor and the "*cultural fit*" bias identified by the report, poses less of a risk.

Question 5 – Scope of mandatory joint audits – a) should the requirement to have a joint audit apply to all FTSE 350 or potentially go wider by including large private companies?

The AIC does not support mandatory joint audits for any companies. However, if this requirement is adopted, the AIC **recommends** that it only applies to FTSE 350 companies. The AIC also **recommends** that investment companies, as defined (see Q5b below),should be out of scope.

Question 5 – Scope of mandatory joint audits – b) what types of companies (if any) should be excluded from a requirement for joint audit?

The AIC **recommends** any requirements that are brought in for mandatory joint audits should not apply to investment companies (being those companies set out in our response to Q4 above). The reasons for this are set out below.

Structure of investment companies

As outlined above, the majority of investment companies have independent boards comprised of non-executive directors. There are no executive directors or employees. The investment company has contracts in place with each of its service providers and these are reviewed on a regular basis by the board.

Investment companies do not have complex group structures, international divisions or complex accounts. For investment companies with unquoted investments, the most challenging part of the audit is the ownership and valuation of the investments. Whilst this remains an important area of focus for investment companies with quoted investments, it is likely to be less of a key risk. The completeness of the revenue and the calculation of the investment management fee are also likely to be key considerations for the auditor.

Investments held by an investment company are managed by an investment manager and those that can be held in custody, such as equities and bonds, are held by a custodian.

Regulatory environment

The Alternative Investment Fund Managers Directive (AIFMD) places certain obligations on investment companies and their managers over certain size thresholds (this includes the majority of investment companies). These include:

1. Having a valuation of the investments performed by the Alternative Investment Fund Manager (AIFM), which may be the investment manager, or an external valuer at least once a year. The valuer is also required to have appropriate procedures so that a proper and independent valuation of the investment can be performed. The valuation function can only be performed by the AIFM if it is functionally independent from the portfolio management function and no conflicts of interest exist.
2. Appointing a depositary whose function it is to safeguard the assets of the company. The depositary must also ensure that the investment company's cash flows are monitored and payments, such as dividend income, are correctly received. For assets that are held in custody (e.g. equities and bonds) the depositary has strict liability for those assets and they must be segregated and kept in a separate account, so they can be identified as belonging to the investment company.

   For assets that are not held in custody (e.g. derivatives, real estate and private equity instruments) the depositary must verify the ownership of the assets and maintain records of those assets. The depositary is appointed by the investment company, and it reports to the company.
3. Requiring the AIFM to have permanent risk management and compliance functions with adequate risk management controls, procedures and systems and review these annually. Where proportionate the AIFM must also have an internal audit function. The AIFM is required to have adequate systems in place to identify, manage, measure and monitor all the risks applicable to the investment fund strategy. These rules formalise the risk management process.

The requirements of the AIFMD provide the board and shareholders of an investment company with additional comfort regarding the valuation and ownership of its investments, along with the risks involved in its investment portfolio. This sits alongside the work the auditor performs. Having a mandatory joint audit would not provide the board or shareholders with any additional protection.

Division of investment company audits

The audits of investment companies would be difficult to divide sensibly between two auditors. The investment portfolio is the key constituent. It has a direct relationship to the income received in the year and the year end net asset value (of which the investment valuation comprises a significant part) is the basis on which most management fees are calculated. Without the knowledge gained from the audit work on the investment portfolio, it would be difficult for an auditor to provide any significant scrutiny and challenge on the completeness of the revenue or the calculation of the management fee.

Investment company audit fees

Investment company audit fees tend to be significantly lower than more complex trading businesses, either in the FTSE 350 or large privately owned companies.

For example, the largest investment company by total assets is Scottish Mortgage, which is in the FTSE 100. Its annual report and accounts for the year ended 31 March 2018 shows fees paid to the auditor for audit services of £44k.

Relatively straight-forward companies to audit, such as investment companies, should not have to incur the additional cost burden of having a mandatory joint audit. The costs of requiring investment companies to have mandatory joint audits would not be in line with the governments or regulators commitment to proportionate regulation.

For these reasons, the AIC **recommends** any requirement for a mandatory joint audit should not apply to investment companies.

Question 25 – What should be the scope (i.e. which companies) and frequency of peer reviews, if used as a regulatory tool?

If peer reviews are implemented, these should be reserved for high risk companies.

The AIC **recommends** investment companies are excluded from the scope of peer reviews and from the proposed levy on the audit fees to fund these reviews. Investment companies are relatively straight-forward companies to audit. They are subject to the AIFMD and other rules which do not apply to conventional trading companies. These rules provide additional checks and balances on the valuation and ownership of investments which are the key figures in an investment company's financial statements. See our response to question 5.

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To discuss the issues raised in this paper please contact:

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