



ShareSoc

UK Individual Shareholders Society

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Dipen Gadhia
Inquiry Manager
Competition Commission

Via email to: dipen.gadhia@cc.gsi.gov.uk

05 April 2013

Statutory Audit Market Inquiry

Dear Mr Gadhia,

I attach responses to your questions on behalf of our organisation on the above subject. Answers are given in red.

We have consulted our members on this response before submitting it to you.

Yours sincerely

Roger W. Lawson
Chairman

About the UK Individual Shareholders Society (ShareSoc)

ShareSoc represents and supports individual investors who invest in the UK stock market (and who own as much as 30% of the shares in UK public companies in aggregate). We are a mutual association controlled by our members with "not-for-profit" articles and incorporated as a company limited by guarantee. The organisation is financed by member subscriptions, donations from supporters and by the services it provides to members. More information on ShareSoc can be obtained from our web site at www.sharesoc.org .

Investor Questionnaire

Mandatory tendering

Under the FRC's recently revised UK Corporate Governance Code,¹ FTSE 350 companies should put their external audit contract out to tender at least every 10 years or explain to shareholders why they have not done so. An option we are considering is a shorter period of 5 to 7 years, and a requirement that such tendering should be mandatory. We are also considering whether tendering should be conducted on an 'open book' basis in which tendering firms have access to relevant information from the files of an incumbent auditor.

1. Please explain (giving reasons for your answers):

- (a) Whether requiring FTSE 350 companies to tender more frequently than every 10 years will benefit shareholders.

Answer: A more frequent tendering period than 10 years would be preferable in our view so as to ensure that the fees being paid by a company were reasonably competitive and to stimulate more general competition in the market for audit services. It will encourage more frequent changes of auditors and this will tend to increase their independence from the influence of company management. Tendering auditors should have access to information about previous audits including past Audit Reports so as to enable them to judge the effort required to perform an audit.

- (b) If so, should the tendering period be 5 or 7 years or some alternative period?

Answer: a period of 5 years would be preferable.

- (c) Should any obligation to tender be mandatory, or should it be on a 'comply or explain' basis?

Answer: we suggest it should be mandatory. There is of course still likely to be discretion available to the company as to whether they accept any tender so it does not automatically mean that auditors will change.

- (d) Are there issues or costs that you as a shareholder/investor foresee arising from mandatory tendering? How do such concerns (if any) compare with the benefits?

Answer: Obviously there will be some costs to auditors from more frequent tendering because of the expense required to prepare a tender, and that might raise the general level of audit firm costs which will need to be recouped somehow – presumably in slightly higher audit fees in general borne by companies. However our judgment would be that these additional costs are outweighed by the benefits and so far as the companies paying for audit services are concerned, might be generally offset by the benefits of a more competitive market place for audit services.

¹ A copy of the FRC's revised the Corporate Governance Code is available at: <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

Mandatory rotation

Mandatory audit firm rotation means that after a specified period of time FTSE 350 companies must change their audit firm via a tender process. (Under current regulations audit firms must rotate Audit Engagement Partners every five years.) An option we are considering is mandatory rotation of audit firm after 7, 10 or 14 years. We recognise that there may be instances where the choice of audit firm is substantially constrained making it impractical to switch auditor at that time. In such instances we consider there may need to be a mechanism whereby the FRC grants relief from the requirement to switch auditor.

2. Please explain (giving reasons for your answers):

- (a) Whether requiring mandatory rotation for FTSE 350 companies will benefit shareholders.

Answer: Mandatory rotation would encourage independence of auditors from the influence of company management, but we recognize that it does add some burden on companies from having to explain their operations and educate any new audit firm and their staff. There are mixed views among our members on the advisability of mandatory rotation, and although it might improve the competitiveness in the market for audit services, it is not clear that it will improve the quality of audit services - the current commitment to rotate audit partner may provide much of the benefit from such changes.

- (b) If so, should the rotation period be on a 7, 10, or 14 year basis or some alternative period?

Answer: If it was decided to introduce such a rule, we suggest 10 years would be an appropriate timescale.

- (c) Should any obligation to rotate audit firm be mandatory, or should it be on a 'comply or explain' basis, or should a company be able to seek a waiver from the FRC?

Answer: Some flexibility rather than a totally mandatory rule would be preferable. But a "comply or explain" option would not be satisfactory in our view. Such an option often leads to weak explanations of no real substance if you look at the way they operate in the UK Corporate Governance Code. We would prefer an FRC waiver system instead.

- (d) Are there any issues or costs that you as a shareholder/investor foresee arising from mandatory rotation? How do such concerns (if any) compare with the benefits?

Answer: the same cost implications that would arise from more frequent tendering also apply, plus of course the management time incurred by both companies and their auditors as part of the auditor education process mentioned above.

Expanded remit and/or frequency of reviews carried out by the Audit Quality Review team

The Audit Quality Review team currently reports publicly on the performance of audit firms on a periodic basis (ie annually for Big 4 firms, and every two years for other major firms) based on a sample of audits of Public Interest Entities. Reports on individual company audits are kept confidential to the firm and the company in question.

We note that a FTSE 100 company's audit is assessed, on average, every six to seven years and a FTSE 250 company every 11 years.

We are considering a remedy whereby the FRC conducts more frequent or more wide-ranging quality inspections of FTSE 350 audits. This would increase the ability of companies (and their shareholders) to compare the offerings of their existing auditors with those of other audit firms.

3. Have you ever referred to reports from the Audit Quality Review team for information about individual audit firms?

Answer: We are not aware our organisation has ever referred to such reports, and we think it unlikely that our individual members have done so either.

4. If so, please explain (giving details):

- (a) Whether you thought they provided helpful information on the quality of audit firms or audit work more generally
- (b) Whether you would welcome more frequent inspections than currently
- (c) Whether you would welcome more wide-ranging inspections for example covering a wider number of areas
- (d) Whether increased availability of information from the Audit Quality review team would be of value to you as a shareholder/investor in FTSE 350 companies.

5. Currently results are published for the audit firm as a whole. Would you welcome more disclosure of information on inspections of specific company audits?

Answer: Yes we would welcome such disclosure and see no good reason why they should be kept confidential.

Specific shareholder focused remedies

We are considering two types of remedies designed to: (a) provide shareholders with greater influence in the appointment and reappointment of auditors; and (b) afford shareholders with more information about audit quality, so that they can better exercise their rights and otherwise influence the auditor appointment decision.

Enhanced shareholder – auditor engagement

6. Legally, shareholders appoint auditors. In practice, they often follow the recommendations of the Board. To help us understand this better:

- (a) In what circumstances, if at all, do you vote against Board recommendations on auditor re/appointment?

Answer: It is rare to vote against the reappointment of an auditor, but our members would be likely to do so if they thought that the auditors had not been as diligent as they could have been (particularly regarding past accounts where for example they had been restated due to past errors, undisclosed fraud, etc) or where there are specific issues in the Report & Accounts presented to the meeting which is voting for reappointment. Some members might also object to the audit firm receiving fees for consulting services provided to the company as they believe it prejudices their independence.

- (b) If you use a proxy voting agency, do you give them any guidance as to how to exercise votes on auditor re/appointment? (if so, please detail)

Answer: our members generally do not use proxy voting agencies.

- (c) (As applicable) is there anything that prevents you from not following Board recommendations?

Answer: No. But investors generally trust the board of directors of a company to make management decisions and hence would not interfere in the recommendations re appointment of auditors unless there was good reason.

- (d) If so, what would make you more likely to exercise your votes more actively, rather than follow Board recommendations?

Answer: The key issue here is obviously that there is typically only one candidate being voted upon (i.e. one resolution to appoint a single audit firm recommended by the directors). If there was a choice of more than one audit firm and the quoted audit fee shown, then shareholders might more actively make a choice.

- (e) Would further information help you in exercising your voting rights with regard to auditor re/appointment? If so what?

Answer: A clear statement of the length of service of the auditor, when the role was last tendered for, and the costs would be advantageous. This information is often present somewhere in the Annual Report but frequently difficult to locate.

We have identified certain options in relation to increasing shareholder engagement.

7. Do you wish to increase direct shareholder engagement with auditors?

Answer: Yes it would be preferable. Shareholders often have questions on the accounts of companies, particularly when a company has financial difficulties, and getting answers to questions out of the company itself can often be difficult.

8. If so, in relation to the options we have identified below, which of the following (if any) would you support and which would have greatest positive effect on your engagement with auditor selection and the audit process? Please respond by indicating on a scale of one to five, five being "strongly disagree", three being "no view" and one being "strongly agree".

- (a) Changing shareholder voting requirements to include an option to vote for holding a tender for external audit in the next financial year.

Answer: We don't particularly see how this would improve "engagement" or be otherwise beneficial, and we generally oppose complications being added to the voting process.

- (b) Requiring an enhanced level of votes (ie more than a simple majority) to reappoint the audit firm if it was proposed that an auditor should remain in place after a mandatory tender.

Answer: This might be preferable but again it would complicate the voting process and explanations so we are not in favour of this.

- (c) Requiring the audit engagement partner to present directly to shareholders at AGMs (or other open shareholder forums) on the conduct and outcome of the audit.

Answer: we would support this proposal so long as it did not turn into the reading of a "boilerplate" paragraph of text, and that there was a requirement to answer questions from shareholders. Note though that often questions to auditors are on quite complex technical matters and an AGM is not the best forum for technical questions. Such questions need ideally to be put in advance and then answered in public and in writing.

- (d) Requiring the Audit Committee Chair to have a dedicated Question and Answer agenda item at AGMs (or other open shareholder forums) in which he/she answered questions directly on audit or financial reporting.

Answer: In many AGMs there would be few relevant questions, nor time to cover them. And see above under 8 (c)) our comments about questions to auditors.

9. In relation to the possible options outlined above, are there practical difficulties, costs or other concerns that we should be aware of?

Answer: only those already given.

10. We have been told that institutional investors rarely attend AGMs. Is this your experience and if so why? Do you think that options (c) and (d) could encourage more constructive use of AGMs?

Answer: It is certainly true that institutional investors rarely attend AGMs. This seems to be because they often have private meetings with companies which they find less time consuming and more productive. Also of course many institutions are now located overseas and hence would find it tedious and expensive to attend AGMs. What we really need is more encouragement to attend AGMs by reconsidering the format and purpose of such meetings. For example, we would like all AGMs to be web-cast in real time, with phoned-in questions.

We doubt that options (c) and (d) would particularly encourage attendance at AGMs.

11. Do you see any practical difficulties in increasing shareholder engagement? Are there other options which would engage shareholders more with the audit process that you think we should consider?

Answer: Shareholders would be more engaged if they had some direct representation on the audit committee. We have also suggested in the past (see www.sharesoc.org/Shareholder%20Committees.pdf) that a “shareholder committee” be formed to advise the board of directors, and the Audit Committee, on the appointment and remuneration of the auditors.

Extended reporting requirements

We are aware that the FRC have recently revised the Corporate Governance Code to require the Annual Report to provide (on a ‘comply or explain’ basis) information describing the work of the Audit Committee. We also note that the FRC is consulting on a revision to ISA 700 (which sets out auditors’ responsibility to form an opinion on financial statements) to require fuller disclosure in the auditor’s report.²

12. We would like to understand your views on the extent to which these initiatives might provide shareholders with relevant information about audit quality:

- (a) To what extent do you think they will help shareholders to better engage with companies on auditor selection?

Answer: We believe this will have only a minor impact on that issue.

- (b) As an investor what (if any) benefits and costs do you see arising from these initiatives?

Answer: we see minimal benefits arising, although the cost impact should be small.

² A copy of the FRC’s recent consultations on its revision to ISA 700 is available at: [https://www.frc.org.uk/getattachment/d24bb652-e319-46a4-add5-793d518a035b/Consultation-Paper-Revision-to-ISA-\(UK-and-Ireland.aspx](https://www.frc.org.uk/getattachment/d24bb652-e319-46a4-add5-793d518a035b/Consultation-Paper-Revision-to-ISA-(UK-and-Ireland.aspx)

13. Are the recent initiatives effective in giving you the information that you would find it useful to receive in relation to the audit?

Answer: The audit function and what it produces is generally a minor aspect of the information required by investors about the affairs of a company, and hence these initiatives are unlikely to have a significant impact except in very specific circumstances and in certain types of companies.

14. If not, would further disclosure regarding the audit process or findings in either the Audit Committee or Auditor's report be of benefit to you? If so:

(a) What would you like to be disclosed?

Answer: disclosure of the contents of the Audit Report might be beneficial to shareholders although companies would be likely to object in that it might disclose commercially sensitive information about the internal operations of the company. Perhaps a summary of the key issues raised might a good compromise.

(b) When would you like it to be disclosed (in the annual reporting cycle)?

Answer: with the Annual Report and as part of it.

(c) Would more disclosure affect your investment decisions or how you would vote in appointing auditors? If so, how?

Answer: It might not have a direct impact on that decision but it might reveal the thoroughness and hence quality of the audit.

(d) What costs (if any) do you see arising from further disclosure? How do any such costs compare with the benefits?

Answer: costs should be quite small and the benefits should outweigh them.

The package of remedies

In addition to those remedies mentioned above, we are also considering remedies to:

- (a) Prohibit 'Big 4' only clauses in certain loan documentation
- (b) Strengthen accountability of the External Auditor to the Audit Committee

15. Overall, what package of remedies would you like to see? Please comment on any other remedies that we have not considered in detail that you think would improve the market outcome.

Answer: In general, we would be opposed to terms in commercial contracts such as loan documentation that inhibit the freedom of action of the parties to the contract. If lenders are only willing to lend on the basis that the auditors used are of a certain size and reputation, then that is their rightful commercial judgment.

We are not clear how the accountability of the auditors to the Audit Committee could be improved.

In general we would wish to see the accountability of auditors to shareholders improved by the reversal of the Caparo judgement. Auditors should have an implied contract with shareholders, not just the company because they are reporting to the members, not just the board of directors. Contracts that limit the liability of auditors should also be outlawed so as to encourage high quality audits.

We would also like to see severe restrictions on the provision of non-audit services by audit firms to companies which they audit. This potentially prejudices their audit opinions and also reduces market competition for audit services.

16. Overall what net benefit, if any, do you think the remedies we are considering will have for shareholders (either individually or in combination)?

Answer: we believe there will be an overall net benefit to shareholders.

17. Are there any other comments on the benefits, effectiveness, or costs of particular remedies that you would like to make?

Answer: We recognize that the Competition Commission might be focused on competition in the Audit market, and we accept that there is limited price competition in the market at present due to the structure of the market, which means in some cases that companies can overpay for audit services, However, one of our major concerns is to improve the quality of audits in public companies and over stimulating price competition might prejudice that objective.