EU AUDIT PROPOSALS

THE VIEWS OF UK INSTITUTIONAL INVESTORS

Introduction

This memorandum sets out the views of the Institutional Investor Committee (IIC), which comprises the main trade bodies that represent institutional investment in the UK, on the European Commission's proposed Regulation regarding the statutory audit of public-interest entities and amending Directive on statutory audits of annual and consolidated accounts (the EU Proposals).

The IIC is made up of representatives from the Association of British Insurers (ABI), the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF). The ABI represents the UK's insurance, investment and long-term savings industry. IMA represents the asset management industry operating in the UK. Its members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. The National Association of Pension Funds is the voice of workplace pensions in the UK and represents 1,200 pension schemes with some 15 million members.

The members of these associations together manage/own £4 trillion of assets, which are invested globally, and are major investors in companies whose securities are traded on regulated markets. We believe that the main purpose of accounts is primarily to provide investors, the holders of ordinary shares, with the information they need for the purposes of deciding to buy, sell or hold their shares and fulfilling their responsibilities as owners – assessing company management and the strategies adopted, stewardship. Quality audits are pivotal to this and for ensuring that markets value the information reported and investors believe what they are told about the financial position of their investee companies.

The EU proposals aim to address a number of the perceived issues around audit, including those around auditor independence and objectivity which may be compromised by long term relationships with clients and non-audit services, the limited number of audit firms with the capabilities to audit large multinational entities, and the nature of auditors' communications with investors.

UK institutional investors support these objectives and a number of the EU Proposals. However, there are other of the Proposals where they are concerned that they could have unintended adverse consequences. We set these out below and our alternative suggestions.

Institutional Investor Committee
3rd Floor, 65 Kingsway London WC2B 6TD
Tel: +44(0)20 7269 4616 Fax: +44(0)20 7831 9975
www.iicomm.org

We would be pleased to engage further on this subject as it is considered by the European Parliament. Contacts are:

Liz Murrall
Director, Corporate Governance & Reporting
Investment Management Association
65 Kingsway
LONDON, WC2B 6TD
Tel: +44 (0) 207 269 4668
Email: lmurrall@investmentuk.org

Michael McKersie
Assistant Director, Head of Capital Markets
Association of British Insurers
51 Gresham Street
LONDON, EC2V 7HQ
Tel: +44 (0)20 7216 7659
Email: Michael.mckersie@abi.org.uk

David Paterson
Head of Corporate Governance
National Association of Pension Funds
Cheapside House
138 Cheapside
LONDON, EC2V 6AE
Tel: +44 (0) 207 601 1726
Email: David.Paterson@napf.co.uk

1 Scope

The Proposals apply to Public Interest Entities (PIEs). This includes credit institutions, insurance undertakings, issuers of securities admitted to trading on a regulated market, payment institutions, UCITS, electronic money institutions and alternative investment funds (Article 1c of the Directive).

Investors' views. Investors are concerned that certain of these entities, in particular UCITS and alternative investment funds, are numerous and small, and the costs of implementing the proposals would outweigh any benefits. Increasing costs reduce investor returns. The UCITS Directive already provides a robust regulatory framework, which is being further enhanced specifically in the light of the Madoff fraud and the forthcoming AIFM Directive provides a tailored robust framework for alternative investment funds.

Specifically in response to events around Madoff, the role of the depositary is being strengthened in both the UCITS and AIFM Directives. Previously, only UCITS were required to have depositaries. With the AIFM Directive, which comes into force in July 2013, all EU investment funds will have to have a depositary which is responsible for the safekeeping of assets, and oversight and monitoring of the fund. The depositaries will not be able to delegate oversight or monitoring, and the depositary liability regime has been significantly strengthened. It is the independent and robust oversight by the depositary, together with the fact that it, not the fund manager, safekeeps a fund's assets that provides a clear rationale for not including EU funds, subject to UCITS or the AIFM Directives, from the scope of EU audit reform.

2. Mandatory rotation

The Proposals require firms to rotate after 6 years. This period can be extended to 9 years if joint audits are performed. Joint audits are not obligatory but are encouraged. There is to be a cooling off period of 4 years before the audit firm can be engaged again by the same client (Article 33 of the Regulation).

Investors' views. Investors are concerned that where auditors hold office for long periods, this can materially impact their independence and objectivity which are vital in ensuring audit quality. There is the risk of a reduced willingness to challenge management, especially where audit firms foster other non-audit relationships with their audit clients.

Reduction in average tenure represents a well-founded public policy objective and one that audit committees on behalf of shareholders/investors should seek to achieve. There needs to be a strong measure of accountability to shareholders in this regard. In the UK, the Financial Reporting Council has, effective from October 2012 within the comply-or-explain framework under the UK Corporate Governance Code, introduced a requirement for audit committees to account to shareholders for their policy in this regard and, if applicable, to provide an explanation of departure from the expectation that no later than 10 years into an audit firm's tenure, the appointment will be put out to tender. This tender would be open to the incumbent as well as other firms. UK investors support these amendments to the UK Corporate Governance Code although some would like to see mandatory tendering more frequently, perhaps every five to seven years.

In any event it is difficult to envisage a convincing explanation of a decision not to tender after a tenure of 15 years. Thus investors would support the introduction of a "mandatory tendering" requirement after 15 years. They consider this could help improve competition and note that many other commercial relationships are subject to regular tendering.

Most UK investors consider that imposition of an absolute requirement to rotate an auditor after an arbitrary period of time is undesirable. A "mandatory rotation requirement" could mean that companies are forced to change auditor at a time when the existing auditor's familiarity with the business would benefit the audit such as when there is a major acquisition or merger. It could also conceal the fact that an auditor has stood down for a particular reason and prevent an auditor being reappointed when they are the preferred choice of both management and investors. They consider that it should be for a company, possibly through its audit committee of non-executives, to decide the best time to change auditor in conjunction with its shareholders/investors. A mandatory rotation requirement disenfranchises both.

A minority of investors, primarily pension funds, consider that the application of mandatory rotation at 15 years would be desirable. There is a good case that a "fresh pair of eyes" introduces a check on incumbent audit firms' work, and ensures the audit is not unduly influenced by historical judgments as well as the client's management. However, there is no support for the European Commission's proposal for a 6 year limit (9 in the case of joint audits). This would clearly be costly and disruptive to companies, and would not be in the best interests of investors/shareholders or other parties with an interest in high quality audits. Nor do investors see any practical benefit in applying a 25-year restriction on the tenure of an audit firm as some are now proposing. In practice a clear requirement for retendering should help achieve the greater level of rotation and refreshment that investors are seeking.

As for joint audits, investors believe there are risks that that these could adversely impact audit quality - concerns run to accountability, the danger of missing issues, etc. Joint auditors could also lead to the smaller firm always becoming the junior party and being consigned to this role in future. We do not think that regulation should be seeking to give specific encouragement to the concept.

3. Tendering

The Proposals require PIEs to have an open and transparent tender process when selecting a new auditor. The audited entity's audit committee is to be involved in the process and any appointment to a meeting of shareholders, other than a renewal, is to include at least two choices excluding the incumbent (Article 32 of the Regulation). To promote choice, one of the firms is to be a smaller firm. Auditors are to be appointed for a two year minimum term which for a PIE could only be renewed once (Article 33 of the Regulation).

Investors' views. Investors welcome the Proposals seeking to make the appointment process more open and transparent. There should be more accountability to investors such that major investors have the opportunity to be involved with auditor appointments.

Investors consider that it is the responsibility of audit committees, as required under the UK Corporate Governance Code, to make a clear recommendation to shareholders on which firm should be appointed as auditor, and for shareholders to have the responsibility of approving the appointment and reappointment each year. This annual vote is valued by investors, but the two year minimum period does not allow for this nor for the auditor resigning or being dismissed within this period. In addition, it would be meaningless to provide a choice of two, excluding the incumbent, one of which is a smaller firm due to the limited number of firms that could undertake the audit of major groups. We also think it must be clarified that nothing in any requirement to put forward the names of two audit firms to shareholders will preclude the audit committee providing a recommendation.

4. Non-audit services

The Proposals prohibit audit firms from providing non-audit services to their audit clients (Article 10.3 of the Regulation). Fees for "related financial audit services" are limited to 10 per cent of the audit fees (Article 9 of the Regulation). In addition," large" audit firms are obliged to separate audit activities from all other activities in order to avoid risks of conflict of interest (Article 10.5 of the Regulation).

Investors' views. Investors consider that non-audit services, particularly those of an advisory nature, can introduce a potential conflict of interest and have an impact on independence. Where there is a clear conflict then firms should be prohibited from providing such services to their audit clients and a list of prohibited services should be prescribed. On the other hand, where there is no clear conflict there may be benefits in firms providing certain services.

Thus investors do not support "large" audit firms only being allowed to focus on statutory audits and not providing other services. This could also affect the firms' ability to attract and retain staff and impact audit quality.

Moreover, restricting other audit firms to only being able to provide "related financial audit services" as they are termed, such as compliance work and regulatory returns, to 10 per cent of the audit fee is too restrictive and establishes an artificial barrier. Such services can be important to companies and very often the auditor can be the best supplier especially if the need is urgent.

Nevertheless, investors believe restrictions on non-audit work are necessary. In particular, audit should be the key service and when the fees for non-audit services are significantly more than the fees for the audit, independence and objectivity can be compromised. In general it should be for a company's audit committee to decide whether it is appropriate for the auditor to provide such services. But where the fees for non-audit work are more than 100 per cent of the audit fee, the audit committee should be required to bring the ratio down within the next twelve months or select a new audit firm at the next tender. An EU measure is helpful in that standards on independence and non-audit and audit related services have been implemented differently throughout the EU. However, it should be remembered that investors invest internationally.

5. Audit reports

The EU Proposals set out two pages of disclosures for the audit report within four pages or 10,000 characters (Article 22 of the Regulation).

Investors' views. Investors would like to see a more enlightening audit opinion, but consider the disclosures proposed are too onerous and would not necessarily benefit investors. Undoubtedly the usefulness of the current audit report to investors is undermined by its binary opinion, pass or fail, and boilerplate, technical language. There are also questions as to whether reports evidence auditor skepticism and audit quality.

Investors would welcome more informative reporting by both the audit committee and the auditor. This could give them more confidence that auditors have challenged management and how skepticism is working in practice through the reporting of, say, the top ten contentious issues, including some commentary on what had arisen during the course of the audit process. For example:

- key areas of judgement;
- key estimates;
- any fraud identified, other than that which is petty;
- any significant weaknesses in the financial systems and controls identified during the course of the audit and the steps being taken to remedy them;
- the significant assumptions for determining fair values and whether the models and markets on which the valuations are based are sufficiently robust to give reliable valuations;
- the factors taken into account in agreeing any material write downs and that such write downs are sufficiently prudent;
- material securitisation arrangements and off balance sheet arrangements;
- the nature and level of non-audit services provided; and
- the length of time the auditor has held office.

Investors could then raise these with the company.

6. Audit committees

Under the EU Proposals every PIE is to have an audit committee. Audit committees are to be strengthened with a majority of members independent and at least one member with competence in audit and another in accounting and audit (Article 31 of the Regulation).

Investors' views. Investors generally support these Proposals in that requirements for audit committees are different throughout the EU and would benefit from better harmonization. However, the level of competence is quite onerous and it may be difficult for companies to meet such requirements. Investors consider that the UK's requirement whereby at least one member of the audit committee has recent and relevant financial experience should be sufficient and that if there is to be a requirement for two members to have relevant experience it should be restricted to large companies only.

7 EU-wide adoption of ISAs

The EU Proposals require that audits throughout the EU are carried out in accordance with ISAs, enhancing audit quality in the provision of EU-wide audit services (Article 20 of the Regulation).

Investors' views. Again this is supported in that audits throughout the EU are not necessarily carried out under the same standards. It is equally important, however, that ISA pluses are retained as these add value in particular markets.

3rd December2012