

# Auditor Regulation

A response to the Department for Business Innovation & Skills (BIS) consultation on the implications of the EU and wider reforms

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## Introduction

NEST welcomes BIS's move to consult on a range of reforms that enhance confidence in and strengthen the audit regime. We strongly agree that the audit function should be an essential safeguard to provide independent assurance that the financial reporting of businesses properly reflects their circumstances.

In general we welcome legislative action on improvements to the role and operation of external audit.

## About us

NEST is a defined contribution (DC) pension scheme that UK employers can use to meet the new workplace pension duties set out in the Pensions Act 2008. NEST is designed to be an easy-to-use, low-charge scheme. It has a public service obligation to accept employers of any size that want to use it to comply with their new duties.

NEST Corporation is the Trustee body that runs NEST. It's made up of a Chair and up to 14 additional Trustee Members. The Trustee Members set NEST's strategic direction and objectives. Their duties are the fiduciary duties of any trustee. They include acting in the best interests of the members whose money it holds in trust, and to abide by the regulatory framework the scheme exists within.

At the time of writing NEST is working with over 13,000 employers and has over 1.9 million members. A key aim of the scheme is to provide members the benefits of a good value, quality occupational pension scheme, whoever their employer and however much they save.

NEST invests and owns stakes in thousands of companies globally and is likely to be among the very largest institutional asset owners in Europe. How these companies are governed and run is a concern of the members of NEST as it will be a determinant of the performance of NEST's funds and members' incomes in retirement.

## About our response

We are responding to questions from selected sections where we believe we can contribute to the debate. Some of this contribution is based on the viewpoints of a number of FTSE-listed companies with whom we have engaged over the last year.

We respond to questions in the following sections:

4.3 Audit fees and non-audit services

4.4 Tendering and duration of audit engagements

4.5 Audit reporting and additional reporting to the audit committee

5.4 Audit committees

### 4.3 Audit fees and non-audit services

***Q18. Do you agree that the provisions of Article 4 of the Regulation on the cap on non-audit services should be included in amendments to the FRC's ethical standards for auditors? Please provide information to support your answer.***

We do agree that Article 4 of the regulation on the cap of non-audit services should be included in the amendments to the FRC's ethical standards for auditors.

We believe that having a cap on fee income from permitted non-audit services is an essential procedure that should go towards meeting the Ethical Standards to which auditors are subjected.

Ethical Standards cover the integrity, objectivity and independence for auditors and apply in the audit of financial statements. Large fees paid to auditors for non-audit work may compromise their independence. In that context the potential economic or perceived conflicts that can arise from non-audit work need to be seen to be clearly and effectively addressed.

It's important for audit firm focus that audit work is seen as the most important work to carry out and non-audit work as something additional, not the other way round.

***Q19. What issues, if any, do you consider arise from the application of the provisions on the cap on non-audit services? If there are any, how do you consider these should be addressed?***

We've spoken to several audit committee chairs about the issues that a cap on non-audit services can create. One in particular mentioned that they have an accounting firm supporting them in a number of non-audit work areas, particularly in tax.

However if the tax consultant was appointed as auditor and it exceeded the cap, the company would need to rotate the tax contract as well, making the process slightly more complicated, costly and time consuming.

There's a tangible sense of concern about the potential effect of the cap on audit competition, quality and price. Re-tendering contracts where caps are in place can potentially lead to a reduced number of audit firms tendering and to a situation where the Public Interest Entity (PIE) has to accept a higher price or lower quality audit than it would like.

Addressing this challenge is unlikely to be simple. However, there needs to be more positive industry recognition of audit. Somehow, audit-work needs to be seen as the trophy piece of work to do and non-audit work, even if higher margin, as second best.

Companies should be discouraged by the FRC from automatically awarding non-audit work to their auditors and tender for this work separately from the outset. This should reduce the burden of being forced to do it later if the cap is unexpectedly exceeded.

***Q20. Do you agree that the Member State options in Article 4, to set more stringent requirements on the cap and on the auditor's independence where their total fee income from a PIE exceeds 15% of their total fee income overall, should be capable of being applied by the FRC in its ethical standards for auditors? Please provide information to support your answer.***

Yes. We would welcome closer oversight from FRC if it has concerns about the auditor's independence.

Where the FRC has concerns we agree that stringent requirements on the cap and on the auditor's independence should be sought.

This article may prove to be challenging to smaller audit firms where its client base is small and still developing. This means there may be a need for the standard to be applied to the big four audit firms only, or to audit firms with a total annual income that exceeds a certain amount.

***Q21. Do you agree that the FRC should have the ability to exempt an audit firm from the 70% cap for up to two financial years on an exceptional basis and on application by the firm?***

Yes we think the FRC should have such powers to exempt an audit firm from complying with the cap in exceptional circumstances.

For some firms complying with the cap will have a knock-on effect on other parts of its business.

In the spirit of comply and explain, a company should have the opportunity to explain why they cannot adhere to the cap straightaway and then have a period to make the adjustment.

***Q22. Do you agree that the subject matter of Article 5 of the Regulation on the blacklist of non-audit services, including the possibility of setting more stringent requirements, should be included in amendments to the FRC's ethical standards for auditors? Please provide information to support your answer.***

We believe that while there is merit in including Article 5 in the FRC's ethical standards, doing so will restrict flexibility for firms when they are already under pressure during the period of audit.

***Q23. What issues, if any, do you consider arise from the application of the provisions on the blacklist of non-audit services? If there are any, how do you consider these should be addressed?***

It may be difficult for some firms to exclude all 'black-listed' services during a lengthy period in the year. Doing so will also compel firms to look for another external audit firm if such services do need to be carried out during that period.

This may cause some disruption and the need to hold two separate contracts for work that can be undertaken by one audit firm. This may cause particular burden to smaller PIEs that may not have the resource and capacity to obtain and manage simultaneous contracts.

***Q24. Do you agree that implementation of the revised requirements on ensuring and documenting auditor independence in the 2006 Directive should be implemented primarily via the ethical standards, with amendments to the existing legislation as necessary only to:***

- *underpin the standards? And,*
- *introduce simplifications for audits of small non-PIEs?*

Yes, doing so will uphold the standards.

We support introducing simpler requirements for small non-PIEs that may not have the resource and capacity to implement the necessary structures. Less stringent requirements will also curb red tape allowing small non-PIEs to continue to function efficiently.

***Q25. Do you agree that the existing framework on disclosure by PIEs in notes to their accounts of the audit and non-audit fees they paid their auditor should be adapted, to ensure public disclosure of the information the auditor is required to provide to the competent authority under Article 14 of the Regulation? Please provide information to support your answer.***

Yes. We welcome transparency on the breakdown of audit and non-audit fees.

## 4.4 Tendering and duration of audit engagements

**Q27. Audit Committees must submit a recommendation to the board for the appointment of an auditor. However, under Article 16(1) sub-paragraph (2) of the Regulation, this does not apply where the Member State has provided an alternative system for the appointment of the auditor. The current alternative systems set out in the Companies Act 2006 are where:**

- *the directors appoint the auditor before the company's first accounts meeting;*
- *the directors appoint the auditor to fill a casual vacancy in the office of auditor; and where,*
- *the Secretary of State appoints the auditor because a public company failed to do so.*

**Do you consider that all of these alternative systems for the appointment of an auditor should continue to operate in the UK as they do at present? Are there any other systems that should also be provided for on the grounds that a competitive tender process is not appropriate? Please provide further information to support your answer.**

Under normal circumstances the audit committee submits a recommendation to the board about their preferred choice of external auditor. This is, hopefully, based on a competitive tender in which three or more audit firm bidders make the short list.

In exceptional circumstances alternative systems do need to operate. Where they do, the audit committee chair should provide justification for any alternative appointment procedure in the annual report.

**Q28. Where the PIE is exempted from having an audit committee (eg because it is an unlisted bank), there is no provision as to which body should fulfil the audit committee's role. Do you agree that in this situation the directors should determine the recommendations that should be put to shareholders of the audited entity? Please provide information in support of your answer.**

We believe that in the absence of an audit committee, for example, if there aren't sufficient issues that would warrant constituting a formal audit committee, the board as a whole should determine the recommendations to shareholders.

Alternatively, the role of ensuring a statutory audit could fall to another committee that considers risk and internal control.

Where a PIE is systemically important, for example, because it is an unlisted bank, there may be merit in the firm regulator or the prudential regulator issuing guidance on the determination of audit recommendations.

**Q29. The Government does not intend to take up the option to provide for an extension of the maximum duration of the engagement beyond 10 years where a joint auditor is engaged. Do you agree that the replacement of a single auditor with two joint auditors, one of whom was the original auditor, should be made on the basis of a retender? Please provide further information in support of your answer.**

We agree.

**Q30. We are considering whether provision should be made so that, where a PIE has stated in its annual report it will appoint an auditor based on a tender process before the expiry of the maximum duration of 10 years, it should still be able to take advantage of an extension of the maximum duration beyond ten years, following that tender. Do you agree?**

We agree. Large firms with international, multi-line operations may need extra head-room to start working with their chosen external audit provider later than 10 years, even though the tender process occurred within 10 years.

One possible reason for doing so is that the chief financial officer (CFO) or audit committee chair may change, and the company rightly does not want too much change in the company-audit relationship and process in a single year.

**Q31. We are seeking views on the proposal that for companies that are PIEs the company's plans on retendering should be part of a new element of the annual report setting out key matters for the audit committee on the appointment of auditors. Do you agree that the report should include:**

- a) when the current auditor took up the audit engagement at that company? (Yes / No)
- b) when the audit engagement was last retendered? (Yes / No)
- c) the start of the next accounting year in relation to which the company expects that the auditor appointment will be based on a tender? (Yes / No)
- d) the directors' reasons for considering that the proposed year is in the best interests of the company's members? (Yes / No)

**Do you consider that any other information should be included in addition the above? Please provide further information to support your answer.**

- a. Yes
- b. Yes
- c. Yes
- d. Yes

At this stage we don't see the need for more information in advance of re-tendering.

We suggest explanation could be given following the re-tender process that sets out the PIE's opinion about the effectiveness of the tender process and learning outcomes for next time.

**Q32. We are considering whether, where the statement under point (c) above is included in the company's annual report, and the incumbent auditor is reappointed on the basis of the planned tender process before the expiry of the 10 year maximum duration (e.g. at 7 years), the next tender process should be expected to take effect:**

- (a) after the same period has expired again (ie year 14 in this example);
- (b) after a further 10 years has expired (ie year 17 in this example); or,
- (c) after the same period has expired again, though with the potential to extend it by the full 10 years via further notice from the audit committee in the annual report (ie in this example at year 14 though this could be extended to year 17)?

**Which option would you prefer? Please provide further information in support of your answer.**

The presumed default should be 10 years. Audit committee opinion and behaviour strongly suggest very little desire for more frequent re-tender. This makes (b) the more appropriate option.

The example of seven years in the question is likely to have been the result of exceptional circumstances. This might be, for example, to avoid change of external auditor in the same year as change in CFO or audit committee chair, or if unusual operational events in the PIE mean bringing forward re-tendering is in the PIE's and shareholders' best interests.

**Q33. What issues, if any do you consider arise from the UK's obligation to apply effective, proportionate and dissuasive sanctions for failure to comply with the UK's implementation of the framework on mandatory rotation and retendering? If there are any such issues, how should they be addressed?**

Fines hurt investors so this is not the appropriate route.

The FRC could maintain a public 'name and shame' list onto which are placed both the name of the audit committee chair and CFO of any PIE failing to comply.

Also, where the PIE is a listed company:

- The audit committee chair will hopefully face significant shareholder votes against his or her re-election at the next AGM.
- Investor engagement would hopefully make clear the untenable position of the current audit committee chair.

**Q34. For our impact assessment on the changes we would welcome any estimates that could be provided on:**

*(a) resources that are likely to be deployed by PIEs to tender audit appointments?*

*(b) resources that are deployed by auditors to tender for audit work?*

*(c) additional familiarisation costs that arise for both auditors and the audit client when a new auditor takes up an audit engagement?*

*(d) the extent to which this varies by the size of the PIE?*

We've no quantitative estimates on this. The information provided to us from audit committees has been entirely qualitative.

#### 4.5 Audit reporting and additional reporting to the audit committee

**Q35 What issues, if any, do you consider arise from the inclusion in legislation on audit reporting of a requirement for the auditor to include a statement in the audit report where there is a material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern? How do you consider these should be addressed?**

Whilst legislative disclosures on material uncertainty and going concern are positive, the PIE may be concerned about the perception of its customers and investors.

In light of this the audit report should carefully assess the risks of material uncertainty and provide sufficient explanation of how the auditor applied the concept of materiality in planning and performing the audit. This is so that investors are clearly informed.

The disclosure of such statements may encourage more frequent and thorough shareholder engagement with companies in discussion of these additional statements.

**Q36 Do you agree that the provisions of Article 10 of the Regulation on the audit report should be included in amendments to the FRC's International Standards for Auditing (UK and Ireland)? Please provide information to support your answer.**

Yes we believe Article 10 of the regulation should form part of the FRC's International Standards for Auditing.

**Q37. What issues, if any, do you consider arise from the application of the provisions of the Regulation on the audit report? If there are any, how do you consider they should be addressed?**

We do not perceive there to be any notable issues. The big four audit firms will have the capacity to be able to easily meet the new provisions.

However for smaller audit firms, PIEs may need to work with the external audit firm to meet the additional requirements and its application in practice.

**Q38. Do you agree that the provisions in Article 11 of the Regulation on the additional report to the audit committee should be included in amendments to the FRC's International Standards for Auditing (UK and Ireland)? Please provide information to support your answer.**

Yes we agree. The requirement of an additional report to the audit committee is an important enhancement to the audit function and one that aids oversight, accountability and transparency. We therefore believe that this provision should be included in the FRC's International Standards.



***Q39. What issues, if any, do you consider arise from the application of the provisions of Article 11 of the Regulation on the additional report to the audit committee? If there are any how should they be addressed?***

Audit committees in some firms may not be used to the level of participation and involvement likely to be required and this could pose as a particular issue.

However this may be an opportune time for firms to look more closely at the resources and composition of their audit committees and refresh them in order to effectively meet the additional obligations.

***Q40. For our impact assessment on the changes, we should particularly welcome data on:***

***(a) additional resources are likely to be needed by the auditor to produce the additional report for the audit committee?***

***(b) the additional annual cost of the audit committee considering the additional report?***

***(c) how these costs vary by size of PIE?***

No comment.

## 5.4 Audit Committees

***Q48. What issues, if any, do you consider arise from the implementation of the new requirements on audit committees via amendments to the existing DTR 7.1 in the FCA Handbook (for companies with securities admitted to trading on a regulated market)?***

The PIE will have to equip the audit committee with the necessary skills and competencies so that they can effectively articulate judgments to others.

There may also be the need to refresh the committee recruiting new members with expertise in the sector which may take some time.

***Q49. What issues, if any, would you consider arise from the implementation via provisions in PRA rules of the new requirements on audit committees for those banks, building societies and insurers that are not required to have an audit committee under DTR 7.1?***

It may be impractical and costly for such entities to implement the new requirements. The PRA should decide which provisions the unlisted PIEs should be realistically able to meet and impose any significant change gradually.

***Q50. For our impact assessment on the changes, we would welcome data on:***

***(a) the numbers of non-listed PIEs that currently do not have an audit committee?***

***(b) the cost of recruiting members to be part of an audit committee?***

***(c) the annual cost of attendance of a member?***

***(d) the auditor's fees for attending audit committee meetings?***

***(e) how these costs vary by size of PIE?***

No comment.