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Investor Questionnaire

The Competition Commission's questionnaire is reproduced in full below. The CRUF response is set out after each question.

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.
- (b) If so, should the tendering period be 5 or 7 years or some alternative period?
- (c) Should any obligation to tender be mandatory, or should it be on a 'comply or explain' basis?
- (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?

CRUF Response

As a general remark that applies to this question and to this questionnaire and the Competition Commission's investigation as a whole, we believe that the value of an audit is not limited in the scope of its benefit to shareholders and this narrow construction in 1 (a) is misplaced.

The value of a statutory audit is far wider than simply a benefit to (existing) shareholders. As investors and analysts, we value the statutory audit as an important part of the investor protection framework in the UK (and elsewhere), benefitting current and potential equity and debt capital holders. But we also recognise its value to a much broader group of actually or potentially interested

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>



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economic stakeholders as well as parties that may have no direct economic relationship with the company at all, notwithstanding any limitations in law or otherwise on the duties owed by auditors.

Our specific answers to Question 1 are:

a) We do not believe that requiring companies to tender more frequently than every 10 years would benefit shareholders, or for that matter other stakeholders in audit quality and the reliability of audited reporting. In our view more frequent tendering would impose extra costs without delivering any material gain in quality and runs the risk of higher annual costs if auditors are to recover additional fixed costs over potentially shorter periods.

b) N/A

c) "comply or explain". See a) above for reasons why we believe a mandatory approach is inappropriate.

d) Investors will not suffer any direct costs from mandatory tendering, but they will obviously suffer the effects of any increased costs indirectly through reduced shareholder returns. These increased costs could be significant both for companies and auditors due to time spent on the process, tendering costs, and distraction of managerial focus. Since we do not see any benefit from mandatory rotation more frequently than every 10 years, the costs would be greater.

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



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CRUF Response

We see mandatory rotation as amounting to change for change's sake. We believe it would be better to enhance the role of the audit committee in calling auditors to account. Mandatory rotation would rather serve to diminish the audit committee role, reducing incentives for audit improvement as the mandatory date approaches or forcing curtailment of an otherwise effective audit relationship. We also do not support it because the more complex a company, the more complex will be the audit and the greater the period after a change of auditors – as much as two to three years – before a new firm might be expected to be fully up to speed with the demands that such complexity imposes.

We are unconvinced of any benefit necessarily arising and very concerned about the threat to audit quality posed by forced imposition of such a change.

If it is felt from a broader policy perspective that changing auditors every now and then is to be encouraged, we would prefer a 'comply or explain' approach to be taken, as being both lower cost, and more informative (and therefore beneficial to shareholders and other stakeholders).

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?

CRUF Response

Yes. However, few CRUF members would read these as a matter of course. More important is the public reassurance they provide that inspections take place.

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



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- (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.

CRUF Response

a) The published reports are necessarily general in nature in their coverage of specific firms. The scope of the inspections is aimed at compliance with auditing standards and professional requirements reflected in procedures. The AIU focuses on process. Outcomes – the financial statements – are the responsibility of the FRRP. AIU reports provide important but limited comfort on the adequacy of process, which is helpful. Only more recently has there been more emphasis on the mark of a good audit: demonstrable evidence of the exercise of independent judgement on the way towards the financial reporting covered by the audit report.

b) Frequency is more of an issue for "other firms", rather than the "major firms" reviewed annually. The AIU 2008/9 report covering a difficult period in markets generally suggests frequency for "other firms" should be kept under review:

"The AIU considered that the issues identified from its inspection work at other firms were not dissimilar in nature to those identified at the major firms. However, the extent of issues identified and the proportion of audits requiring significant improvement was greater than at the major firms. This may partly reflect the fact that this was the first inspection visit by the AIU to six of the ten firms inspected in 2008/9." <http://frc.org.uk/Our-Work/Publications/AIU/2008-9-Audit-Quality-Inspections-An-Overview.aspx>

(Similar comparisons, between inspection results of major firms and "other firms", do not appear to be a feature of more recent AIU annual reports).

c) As referred to in a) above, we rely on auditors to use an effective audit process to check client accounting processes: that is basic and necessary. However, it is not sufficient for a good audit. The quality of an audit, as opposed to merely its procedural adequacy, is reflected in independent review of areas where accounting judgement is key to what is reported. To deliver intended effects on audit quality, the AIU should continue to emphasise, as it has done in its more recent annual reports, the assessment of auditors on their exercise of independent "professional scepticism".

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?



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CRUF Response

We would prefer the audit committee, with the benefit of full information from the AIU that would not necessarily be appropriate for publication, to report on the fact of a specific inspection, any issues arising and action taken.

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?
 - (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)
 - (c) (As applicable) is there anything that prevents you from not following Board recommendations?
 - (d) If so, what would make you more likely to exercise your votes more actively, rather than follow Board recommendations?
 - (e) Would further information help you in exercising your voting rights with regard to auditor re/appointment? If so what?

CRUF Response

The CRUF is focussed on Corporate Reporting, so questions on voting would not be something we would comment on.

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

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



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CRUF Response

Yes. However, we see the value of such engagement as improved general understanding, especially of issues affecting companies or a sector in general. CRUF members already engage in such discussions with the audit profession and both sides find them useful. We would caution against any expectations that such engagement could address company specific issues in any detail.

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.

(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.

(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.

(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.

CRUF Response

(a) = 2. This option would remove the binary nature of the reappointment vote

(b) = 5,

(c) = 4 since we prefer to see the role of the audit committee strengthened and

(d) = 1 since this would involve meetings holding the audit committee to account

In relation to (d), we would support this not just for shareholder meetings, but also for analyst/investor briefing generally, whether for equity or debt investors. We would repeat, shareholders may legally appoint auditors, but they are not the only investors (i) interested in the quality of an audit or (ii) able to express views to management about audit quality and its impact on their attitude to investing in the company.

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



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CRUF Response

We support 8 (d) and not 8 (c) because we take the view that the audit committee should play an enhanced role in front of investors.

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?

CRUF Response

For CRUF members, the AGM is less important because it is too late. Results presentations and analyst briefings are much more important. However, we would expect stronger engagement of shareholders on auditor issues if they were to be addressed by the chair of the audit committee at these earlier occasions.

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?

CRUF Response

See our answers to 8 and 10. As far as the audit process is concerned, the narrow focus on shareholders is misplaced.

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

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

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?
- (b) When would you like it to be disclosed (in the annual reporting cycle)?
- (c) Would more disclosure affect your investment decisions or how you would vote in appointing auditors? If so, how?
- (d) What costs (if any) do you see arising from further disclosure? How do any such costs compare with the benefits?

CRUF Response

Taking Questions 13 – 14 together, CRUF has engaged with the FRC and fully supports the efforts of the FRC in promoting these changes.

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

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)



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CRUF Response

(a) Agreed

(b) Agreed

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.
16. Overall what net benefit, if any, do you think the remedies we are considering will have for shareholders (either individually or in combination)?
17. Are there any other comments on the benefits, effectiveness, or costs of particular remedies that you would like to make?

CRUF Response

CRUF is concerned at the narrow view of the "market" addressed in the inquiry – the market for audit services – and the focus on shareholders. CRUF disagrees strongly with the proposed remedy of "mandatory rotation" due to its potential for damaging the much wider markets for capital, goods and services that the existence of effective audit facilitates.

The audit requirement is a necessary control on how those running companies, (or for that matter any other type of body where an audit requirement is imposed), account for and report on their stewardship. For shareholders, it is part of the price they must pay for the considerable benefits of limited liability. However, the shareholders are not 'the real audit client' as referred to by Oxera (in their 2006 report to the FRC and the then DTI) when they describe the "Nature of the audit product". This "shareholders = the client/customer" confusion is continued and compounded by the CC in their provisional findings so far and their questionnaire.

The real client is a much wider collection of interests extending to the society as a whole that granted the limited liability privilege. The audit requirement is part of the infrastructure supporting markets generally.

To the extent that major companies have become so great in scale, geographical scope and operational complexity, it has been necessary for audit firms to have similar features. As the AIU itself explains in its 2010/11 Annual Report:

"Firms, and in particular smaller firms, should carefully consider whether they have the appropriate resources, expertise and involvement to undertake audits of multi-national groups to the required standard."

In our view, the value of an audit derives from its quality – not its price. Continuation of effective audit is more important than correcting adverse effects on competition in the narrow market for audit services.



About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters, other official bodies, or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organisations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

Yours sincerely

Peter Elwin

Crispin Southgate
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Peter Reilly
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