nest
NATIONAL
EMPLOYMENT
SAVINGS TRUST

Revisions to the UK Corporate Governance Code and Guidance on Audit Committees

A response to the FRC consultation

Introduction

We are writing to comment on the above consultation document on behalf of the National Employment Savings Trust (NEST)[1].

NEST welcomes the FRC's consultation on Revisions to the UK Corporate Governance Code and Guidance on Audit Committees. As an institutional investor and long-term asset owner, we have a long-standing and far-reaching interest in effective corporate governance and external audit.

We care greatly that our members' savings are put to good use by sound businesses. Firms we are led to believe are sound that later prove not to be are the cause of significant concern and can negatively impact our members' long-term savings. Effective corporate governance and external audit enables us to more confidently invest our members' money in firms that are as fit as auditors declare them to be.

We would like to express our support for regular reviews of the UK Corporate Governance Code. They are an important feature in ensuring that the market does not outgrow the system of good practice intended to guide it.

About us

From October 2012 onwards, employers in the UK will have a statutory duty to enrol some or all of their workers into a pension scheme that meets or exceeds certain legal standards. Employers will be required to make minimum contributions for these workers.

NEST is a defined contribution pension scheme that UK employers can use to meet their new legal duties. NEST is an easy to use, low-charge scheme that has a public service obligation to accept employers of any size or sector that want to use NEST.[2]

NEST Corporation is the Trustee responsible for NEST. It is a non-departmental public body that operates at arm's length from government and is accountable to the UK Parliament through the Department for Work and Pensions (DWP).

The Trustee currently has a Chair and ten Trustee Members who have a fiduciary duty to act in the interests of the members of NEST when taking investment decisions.

[1] We use the term NEST to refer to the scheme's legal name, the National Employment Savings Trust. We sometimes also use it to refer to the scheme's Trustee, the National Employment Savings Trust Corporation.

[2] More information about NEST is available at:
http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/key-facts-myths,PDF.pdf

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. It will be a determinant of the performance of NEST's funds and members' incomes in retirement.

Our response

In our response we provide comments where we feel revisions can be further improved or expanded. Where we do not comment on proposed revisions the FRC should assume we are either in agreement with these changes or have actively decided not to comment at this stage.

Points that we think merit further consideration are in bold.

We believe the external audit function to be a cornerstone of good governance as well as providing important trust in company statements. A sound external audit framework will provide reassurance to both investors and the wider public.

Our view is that parties within the audit process need to see themselves as accountable first and foremost to investors. The external audit is a unique opportunity for the auditor to declare to investors that the publically available annual report represents a true, fair and balanced picture. It should reflect the variety of additional private company information to which the external auditor has access.

We appreciate that the Chief Financial Officer (CFO) will use an expert external auditor as a sounding board and source of expert opinion. We appreciate too that non-audit business will be sought by the audit firm.

The existence of these other priorities makes it all the more vital for investors to be confident the external auditor does not view being accountable to corporate directors as the primary accountability.

More research and evidence on the order of importance of audit firm accountability would be beneficial in helping remove investor uncertainty. It would also help to shape future policy. **We would welcome the FRC encouraging further research and insight in this area.**

General comments on the proposed revisions

We agree that directors should take full responsibility for ensuring the annual report, viewed as a whole, provides a fair and balanced report on their stewardship of the business. The proposed wording reflects this appropriately, we believe.

We are pleased with the current focus on the audit committee within this consultation. We believe that the audit committee should make fuller and more informative disclosure on its work. This is especially important in relation to the issues it considers and the motivations and justifications behind its recommendations to the board. We welcome the focus on greater disclosure within the annual report by the audit committee.

We agree with the introduction of re-tendering at least every 10 years based on comply or explain. This has for too long been an area about which investors have had very little say. The introduction of re-tendering based on comply or explain is an opportunity to invigorate wider choice within the audit market. We see this as vitally important.

We also see the introduction of re-tendering based on comply or explain as an opportunity to dismantle perceptions of inertia by audit committees. This is particularly relevant when it comes to reviewing the external auditor, where tenure is often measured in decades.

The dominance of the so called 'Big Four' is a concern. We note that this is a continuing theme of recent reports, including the Lords inquiry and the European Commission's 2011 Green Paper. **We believe that the FRC should do more to encourage investor debate around improving audit market function.**

We feel that the FRC is right to wait a short while and see the impact that re-tendering has on the demand and supply of audit services. It will enable the FRC to suggest more considered action to awaken the market, such as mandatory rotation and its frequency. That said **we would like the FRC to think about introducing its own guidance around auditor rotation, sooner rather than later, before any prescriptive action is taken at EU level.**

We are pleased to see reference to bondholders in the proposed wording of the Code. The inclusion of bondholder perspectives within the thinking process of companies' corporate governance arrangements heralds an important restoration of interest in prudence, strength and security. As a long-term investor we are interested in such issues, but only alongside companies' growth and development.

We wish to point out that while welcoming the inclusion of bondholder interest, we are aware of the evidence, albeit limited, on 'Big Four' restrictive covenants. This indicates that it is debt holders who ask for clauses on the use of the 'Big Four' audit firms. The potential for the initiative on re-tendering to stimulate the audit market and widen external auditor choice should not be allowed to be lost as a result of greater debt holder interest in the 'Big Four'.

We would welcome the FRC asking audit committees to provide written assurance on the existence of a level playing field in external auditor competition. We would like them to confirm the absence of restrictive covenants in audit firm competition in any financial contracts.

We would also welcome the FRC encouraging greater shareholder involvement in the appointment of the external auditor. This will help to maintain the current focus on the shareholder within the UK Corporate Governance Code. It would also help to ensure that the focus is not diluted by including bondholder interest.

We have no comments on proposals concerning transitional arrangements outlined in the consultation document.

We also have no comments on proposals concerning comply or explain outlined in the consultation document, and welcome the focus on more informative explanation.

We make a small number of specific comments on the proposed revisions below.

Specific comments on the proposed revisions

Draft Revised UK Corporate Governance Code
Audit Committee and Auditors
Section C.3.7

We are mindful of bondholders' greater interest in the 'Big Four' audit firms. **However, we would like to see the audit committee providing written assurance on a level playing field in the market for external audit.**

Draft Revised Guidance on Audit Committees
Communication with Shareholders
Section 5.2

We believe that the re-tendering process should not simply reinforce the existing tendency towards external audit firm concentration. **To this end, we would like to see the audit committee provide written assurance that diversity of bidders is unhindered by the design and requirements of the tender process.**

There is currently uncertainty around who the parties in the audit process view themselves as accountable to. For this reason **we would like to see the FRC ask the audit committee to provide written assurance that auditor selection is based on the ability to discharge audit alone.**