# NEST's Response to Sir John Kingman's Further Questions on Audit

## Overview

NEST is pleased to have the opportunity to respond to the further questions asked by the Secretary of State in a letter to you on 8 October 2018. Our members work for companies where their jobs and security are backed by the finances of their employers. We care that the auditor's role reinforces this security - and the integrity of the payments due and received for their pensions. To summarise the views expressed in our response, we support the following:

1. That Kingman and CMA teams fairly evaluate the two optics through which concentration and competition within the statutory audit market can be examined.
2. The CMA re-recommend to the FRC the 2013 suggestion for a shareholder vote on the Audit Committee Report. This report is no less important than the Remuneration Committee's Report that shareholders currently vote on. The vote would be even more effective if it could be configured to not just be advisory.
3. Encourage Audit Committee Reports to have better explanation on audit scope, procurement, quality, how shareholders' views have been taken into account, and how the right set of balances have been struck.
4. Ensure the work of the Audit Committee is spread more broadly between its Chair and members.
5. Encourage the appointment of more diverse Audit Committee Chairs, deliberately, to encourage the better spread of work. Kingman and CMA teams might consider ensuring this happens through an authorised appointment process in much the same way as the board directors of banks. In this instance the authorisation would look for evidence of activities that demonstrate, over a period, the ability to be independent, critical, and serve shareholders, in order that we move away from the current cast of narrow financial expert. We can see no reason why financial knowledge should not be more broadly spread between the Committee members.
6. Consider asking Audit Committees to apply the FRC's Audit Quality Practice Aid for Audit Committees or explain why that has not been appropriate.
7. To not adopt an independent body to decide auditor appointment.

We do hope that you find our response helpful.

## Introduction

Thank you for inviting NEST to contribute to Sir John Kingman's additional questions about changes in audit that may better promote the interests of users of accounts. Topics include audit scope, procurement, remuneration, and quality. We hope these matters, alongside the Review of the Financial Reporting Council (FRC), will help to complete your and the Competition and Markets Authority's (CMA) picture of the UK audit market.

NEST is a defined contribution (DC) pension scheme that UK employers can use to meet the 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 duties.

NEST Corporation is the Trustee body that runs NEST. The Trustee Members set NEST's strategic direction and objectives. Their duties are the fiduciary duties of any trustee. These include acting in the 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 699,180 employers, has over 7,517,957 members and £4.59 billion in assets under management. 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 in the near future. How these companies are governed, regulated, and run is a concern of the members of NEST as it will be a determinant of the performance of NEST's funds and of members' incomes in retirement.

While NEST is international in its capital allocation, we are a UK registered pension scheme with a membership comprised of workers who are making contributions from UK earnings, giving us a major interest in the performance of the UK capital market.

Our members work for companies where their jobs and security are backed by the finances of their employers. We care that the auditor's role reinforces this security - and the integrity of the payments due and received for their pensions.

## About this response

We have answered the following further questions that the Secretary of State asked of Sir John Kingman:

1. Is there a case for a change in the way audit scope is set?
2. Is there a case for a change in the way the audit is procured?
3. Is there a case for a change in the level of the audit fee?
4. Can audit quality be better secured in a feasible and easily workable way?

This response is set out as follows. Section 1 introduces and provides our view on the overall approach. Section 2 addresses the questions asked by the Secretary of State.

## Section 1

### Introduction

As a major user of company accounts, we understand the value of an independent and unbiased statutory external audit. The auditor's opinion about the true and fair presentation of the statements and reporting provided by the company, as well as the effectiveness of the internal control and governance processes responsible for the financial reporting, provides vital assurance to us. More broadly, that assurance helps markets and the wider public to trust what companies report. Without that trust investors, suppliers, and customers would require far more information about the company, and that would very likely cost significantly more than the amount paid to the auditor.

### Our view on the overall approach to the inquiry

We believe the right approach to the overall audit market inquiry is for both Kingman and CMA teams to apply the two optics through which the statutory audit market can be studied in a fair and balanced manner. For that to happen, the team need to remain alive to the possibility of unconscious bias arising from the current reporting trend that is mainly focused on only one of these optics.

Regarding these two perspectives, we do believe in the possibility that the main optic to view the expected relationship between audit market structure, audit firm conduct, and audit performance (with causation running from structure, through conduct, to performance), while the driving force behind recent criticism, could be misspecified.

We understand the current focus on the audit market. The State guaranteed market is a financial perpetuity for the industry. Barriers to entry exist at the point of registration, as a result of the regulator's technical standards, and in the segment serving large corporate clients. There's a high audit seller concentration ratio among FTSE 350 companies.

Through that optic, parts of the critical accounting literature, industry, and media, believe that changing the structure will improve performance and economic welfare. Doing so is expected to reduce 'audit failures', long audit tenure, the cross-selling of multiple advisory contracts, and the fluidity of skilled labour movement from large accounting and audit companies to industrial corporations, regulators, and government. Suggestions include deep changes to market structure, outlawing types of conduct, and major changes to the industry and company governance.

But what if that relationship is misspecified, and today's industry structure is the result of superior efficiency by some firms? Looked at through the other optic, if greater-than-average profits accrue to companies with greater efficiency and competitive superiority, the market share of those firms that have become large has been earned, not gained or gamed. That might suggest the structure of the industry has come about by the efficient development of deep centres of knowledge excellence in a small number of firms, and the subsequent movement of talent towards the most successful firms (with causation running from conduct, through performance, to structure). Changes to market structure that dismantle company knowledge mosaics useful in the achievement of audit quality could be counterproductive and lead to a loss in economic welfare. If the first optic is misspecified, there's a very real danger that audit quality would at best not improve under some alternative structure.

In the banking sector, which like the audit sector has entry barriers that are legislated, empirical research results categorically support this latter efficient market structure view to banking concentration.

In no way does this viewpoint imply that market inquiry or regulation is unwarranted, only that reliance on factors that only stem from traditional economic theory are. We strongly encourage Kingman and CMA teams to properly evaluate both perspectives above.

Finally, we note one recent concrete example where changing audit market structure did not have the effect on performance as predicted by traditional economic theory. This concerns the introduction of auditor rotation and non-audit caps. Market concentration of the 'big four' subsequently increased slightly within FTSE 350 statutory audits.

## Section 2

### 1. Is there a case for a change in the way audit scope is set?

Legal requirements and entity aspects to one side, the key elements of audit scope concern the degree of testing, evaluation, comparison, and judgements around the information decided to be included within the audit. Over time, these elements have grown in importance partly as a result of the valuation of financial information having shifted from a historic cost to a fair value approach.

That shift in valuation approach has placed more importance on the concept of materiality – meaning the potential for movement in the fair value estimate, of possible misstatement, valuation uncertainty, different than expected distributions of values, and the calculation of the quantitative level below which individual items are considered. Accordingly, both setting audit scope and 'doing' audit involve a substantial qualitative element for which technical standards can't be written. The Audit Committee is critically important to determining these qualitative aspects.

As a result, we believe strongly that Kingman and CMA teams should resurrect the CMA's (formerly the Competition Commission) 2013 recommendation that the FRC introduce an annual shareholder vote on the Audit Committee Report. The Audit Committee Report provides the opportunity to fully explain and justify audit scope, and that's why shareholders should have the opportunity to vote in support or against that. The detail on this proposal can be found in our answer to question 4.

Furthermore, we support the scope of the external audit including tests concerning the protection of shareholder capital. Prior to adoption of International Financial Reporting Standards (IFRS) this would not have been so necessary but IFRS does not provide the reassurance that some shareholders and creditors want concerning confidence in the level of capital support. For example, bonuses paid to executives and dividends paid to shareholders from profits calculated according to fair value might endanger capital if the profit as calculated has not been fully realised in the accounting period. Bringing that analysis within audit scope will also help with conformance to the capital maintenance requirements found in the Companies Act. That some shareholders do want an audit scope that includes capital maintenance is a further reason for a shareholder vote on the Audit Committee Report.

## 2. Is there a case for a change in the way the audit is procured?

The Audit Committee overseas the audit procurement, selects a preferred bidder, and makes a recommendation to the board. In the unlikely event that the board does not accept that recommendation, an explanation will be provided in the Audit Committee Report. In the more usual circumstance of board approval, shareholders vote on the auditor appointment. We fully support this process. We do not support auditor appointment being the responsibility of an independent body. This would disenfranchise shareholders and remove directors' responsibilities.

The Audit Committee is an informed buyer, and there's considerable forward planning. Solicitation by Audit Committee Chairs is designed to encourage bidders and is a means of 'opinion-shopping' to canvas the potential audit firm partner's interpretations of accounting treatments, the audit firm's control environment, approach to component audits, availability of specific audit tools, additional assurance provided, and quality of controls. Potential bidders walk away better briefed about the audit tender, and the Audit Committee Chair walks away more informed about the auditor's alignment with the company's approach, plus perhaps an early stage order of candidate preference. We would prefer this process to be less dominated by the Chair of the Audit Committee.

On the Audit Committee, the Chair is the single most influential individual over the choice of external auditor, but that feels antiquated in today's environment of inclusive decision making. Shareholders pay a high price if the Audit Committee Chair gets it wrong and neither the Financial Conduct Authority (FCA) nor FRC concern themselves with the appointment. Due to interlocking Audit Committee directorships the FTSE 100 has far less than 100 Audit Committee Chairs. There are instances where one individual is the Audit Committee Chair on four large companies.

The Audit Committee Chair is usually a retired finance director, puts in far greater time commitment than other committee members, and has more pronounced networks with the finance and audit teams. We think the imbalance of knowledge and networks in one individual is unhelpful in board decisions on auditor procurement. We believe an improvement would follow if Audit Committees were more balanced in terms of time commitment, workload, communication, and decision making.

A small number of investors are likely to wish for a say at the audit procurement stage, but we believe that selective shareholder input would not be right. It's for Audit Committees to make clear how they have taken shareholder views into account when procuring the statutory external auditor.

There are also several guides from investors that give ideas to Audit Committees about what questions shareholders would like to have asked during audit procurement. Guides include those from the FRC, Investment Association, NEST, and L&G.

## 3. Is there a case for a change in the level of the audit fee?

We believe in the objective of a high-quality audit with a fee that is commensurate. During a procurement, bidders with notably higher fees would typically not make the short list. Thereafter, the research we have performed suggests that Audit Committees next focus on obtaining as much quality as possible for the price quoted. We are satisfied with this process and believe that audit firms should be competing on quality. That would seem to be an effective means to ensure shareholders benefit as improvements in the scope, method, and execution of audit become available on commercial terms.

The Audit Committee Report is potentially the vehicle through which shareholders can see the price-quality trade-off considered by the Audit Committee and the actual expected quality and price point chosen.

We are not aware of any evidence that cost considerations may be constraining the quality of audits.

## 4. Improving audit quality

## 4. a. Can audit quality be better secured in a feasible and easily workable way?

An Audit Committee of a large publicly listed entity is pulled in two directions. On the one hand the Audit Committee works for shareholders so desires audit quality. Rigour, independence, scepticism, and skill are essential inputs. On the other hand, the Audit Committee is employed by the audited entity. The Audit Committee Chair is usually an ex finance director by career; and knows that the auditor’s expertise provides decision useful information chiefly for the entity’s finance director. The Audit Committee Chair’s more everyday relationship is with the entity and the auditor, not the shareholder. Does the Audit Committee always strike an appropriate balance within the audit process between external assurance for shareholders and decision useful information for the audited entity? With the current governance arrangements of Audit Committees our concern is that the answer may be “not always”.

One suggestion is to ensure the work of the Audit Committee is spread more broadly between its Chair and members. A second suggestion is to encourage the appointment of more diverse Audit Committee Chairs, deliberately, to encourage the better spread of work. Kingman and CMA teams might consider ensuring this happens through an authorised appointment process in much the same way as the board directors of banks. In this instance the authorisation would look for evidence of activities that demonstrate, over a period, the ability to be independent, critical, and serve shareholders, in order that we move away from the current cast of narrow financial expert. We can see no reason why financial knowledge should not be more broadly spread between the Committee members. A third suggestion is for the Audit Committee Report to better explain to shareholders the efforts taken to achieve a high-quality audit.

When judging potential audit quality by looking at many of the easier to measure areas, the largest audit firms are hard to tell apart, for example by track record, service level, experience, audit team and audit firm characteristics. Audit Committee Chairs claim to look at deeper aspects, such as judgement, awareness, trust, aptitude, candour, conduct, and ‘personal chemistry’. The Audit Committee Report could discuss this better. Additionally, shareholders would stand to benefit from Audit Committee reporting on metrics about the audit quality they claim to have secured for shareholders.

## 4. b. Can Audit Committees better support high-quality audits?

The importance of high-quality audits has featured strongly on the corporate governance agenda for some time with mixed results. Since 2012 the Corporate Governance Code has included a provision which requires the Audit Committee Report to include an explanation as to how it assessed the effectiveness of the external audit processes. In 2015 the FRC published an Audit Quality Practice Aid for Audit Committees, which includes an evaluation pyramid, but evidence suggests that Audit Committees do not apply this useful guide. The Audit Committee can further support high-quality audits for shareholders by:

- Reducing Audit Committee Chair interlocking directorships and FTSE 100 concentration.
- Encourage the appointment of more diverse Audit Committee Chairs, deliberately, to encourage the better spread of work. Kingman and CMA teams might consider ensuring this happens through an authorised appointment process in much the same way as the board directors of banks. In this instance the authorisation would look for evidence of activities that demonstrate, over a period, the ability to be independent, critical, and serve shareholders, in order that we move away from the current cast of narrow financial expert.
- Having financial knowledge more broadly spread between the Committee members.
- Greater Audit Committee diversity, balance, more evenly distributed time commitment, sharing of workload, and communication with the auditor and audited entity.
- Applying the FRC's Audit Quality Practice Aid.
- Including capital maintenance under audit scope.
- Improved Audit Committee reporting that better covers scope, procurements, how quality is determined, how shareholder views have been taken into account, and how the right balance within the audit process has been achieved between the two outputs provided by the auditor - external assurance and decision useful information.

## 4. c. A vote on the Audit Committee Report

We believe strongly that the CMA's 2013 recommendation for a vote on the Audit Committee Report should be resurrected. The FRC's dismissal of this recommendation in 2015 means the CMA's unadopted recommendation is now largely forgotten.

In October 2013, the CMA issued its final report on the provision of statutory audit services to large companies in the UK. This report contained several recommendations, one of which was that "an advisory vote should be introduced on the Audit Committee Report." The CMA considered that this would increase the Audit Committee's incentives to discharge their responsibilities in the interests of shareholders, in particular to assess the effectiveness of the external audit process and the approach taken to the appointment and reappointment of auditors. We agree. The CMA subsequently published its Order to implement some of its recommendations in September 2014, but this particular remedy did not feature.

On 28 September 2015, the FRC published its consultation paper "Enhancing Confidence in Audit". One of the matters included at section 4 related to the CMA's recommendation from its final report on introducing a vote on the Audit Committee Report. Within that consultation the FRC brought the topic to a fairly hard close, arguing that:

1. Audit already has sufficient coverage within governance and stewardship.
2. It's inappropriate to place emphasis on a particular topic over any other.
3. Shareholders already have sufficient rights to express their opinion on the Audit Committee Report by the annual re-election of the directors.

NEST strongly supported the CMA's recommendation both in 2013, in our response to the FRC in 2015, and today. We would like to see the CMA recommend once more that the FRC give shareholders a vote on the Audit Committee Report. This report is no less important than the Remuneration Committee's Report that shareholders currently vote on. The vote would be even more effective if it could be configured to not just be advisory.



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