

From: [Landell-Mills, Natasha](#)
To: [Comments](#)
Cc: [Summerfield, Daniel](#)
Subject: Submission from a UK pension fund
Date: Wednesday, April 18, 2012 11:02:04 AM
Attachments: [Audit -USS position paper Mar 2012.pdf](#)

Dear sir/madam,

USS is the second largest pension fund in the UK, with approximately £30 bn assets under management. We manage the bulk of our assets in-house, and are long term investors. We take our ownership responsibilities very seriously, and consider ourselves to be relatively unique in the sector as we are both the asset owner and manager. Consequently, we do not suffer from principal agent conflicts that so often exist in the investment sector.

We have been quite actively involved in the ongoing debate over the role of the audit and audit quality in Europe and, more recently, in the UK. We feel strongly that audits play an absolutely vital role in underpinning the integrity of financial markets by offering investors and shareholders assurance that accounts produced by companies present a “true and fair” view of the underlying economic health of companies in which we invest.

The value of the audit is quite evidently critically dependent on the ability of the auditor to ensure their independence and professional scepticism in undertaking the audit. It is therefore our view that the current incentive framework in which auditors operate in Europe and the US are not currently “fit for purpose”. It is clear that where the auditor is paid by the audited entity (while in theory it is the Board who employs the auditor on behalf of shareholders, more often than not management plays an influential role in this process) rather than directly by shareholders, there is the potential for conflicts of interest to emerge. To counter these perverse incentives, it is our opinion that the governance framework in which auditors operate needs to be strengthened.

In our submission to the European Parliament (attached), we highlight a number of proposals for strengthening this governance framework. These ideas are also potentially relevant for your ongoing deliberations, so we are sending them to you now. The key points include:

- **Audit committees strengthened:** We support having two members with some auditing/accounting expertise on Audit Committees at large cap firms.
- **Audit transparency increased:** We would like to see a fuller audit report that draws attention to key areas of judgment, estimates, any weaknesses in the financial system, assumptions underlying fair value estimates, any disagreements with management, etc. This is vital to allowing shareholders to judge the level of audit quality.
- **Mandatory audit firm rotation:** While we are appreciative of transitional costs associated with changing auditors, we think the value of having a fresh pair of eyes review accounting assumptions and practices is vital. Not only does this ensure regular review and robust challenge of management and avoid too cosy a relationship developing between management and the auditor, but it would fundamentally change the incentives facing the incumbent

auditor. The incumbent would take all decisions in the knowledge that at the end of their term, their work would be carefully reviewed by the new auditor. We make two alternate proposals here:

1. Mandatory rotation after two terms. The first term should be 6-7 years. Where the incumbent wins a second term, this should be a shorter 3-4 years to ensure a maximum audit term of 10 years. A buffer of up to 2 year should be permitted in the event of an unexpected crisis. There should be a 'clear water' period of at least 5 years before an auditor can be re-appointed.
 2. Audit Committees are required to set a maximum tenure period for auditors (something less than 15 years) to suit their company's complexity and size. This proposal seeks to address the need for Audit Committees to retain the authority to determine the appropriate audit rotation period, but setting a maximum tenure to safeguard shareholders long term interests.
- **Mandatory competitive tenders:** We would like to see a system of mandatory tendering every 6-7 years, combined with mandatory rotation after 10 (see above). We agree that the tender should involve at least two candidates (excluding incumbent) to ensure genuine competition and to open the market to new entrants. The selection and appointment process needs to become more transparent for shareholders.
 - **Limits on non-audit services:** Auditors should be permitted to undertake audit related work, but we favour restrictions on such work for audit clients combined with a requirement that where the value of non-audit work rises above 50% of the audit work, (perhaps because the audit has a particular expertise in this area of non-audit work), the Audit Committee must select a new audit company at the next tender.

If you would be interested to discuss any of the points made in this submission further, please feel free to contact me.

Kind regards,

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Audit – USS position paper for the European Parliament

20 March 2012

Context

USS is the second largest pension fund in the UK. We manage approximately £30 bn and are unique in that we manage almost all our assets in-house, and do not suffer from agency concerns confronting many pension funds. We take our ownership responsibilities very seriously and invest significant resources and time in monitoring and voting our assets. Financial reports provide the information for us to be able to monitor executives' performance, and the audit of these statements offers a vital assurance that information in company accounts is 'true and fair' (as required by the 4th and 7th Accounting Directives). The quality of the audit is, therefore, of utmost importance.

We believe there are a number of worrying features/developments in the audit market. At a very fundamental level, we are concerned about auditor independence and professional scepticism. Potential conflicts of interest have always been present in the system of auditing, so the challenge is how these are managed. We believe the current system is not delivering, as evidenced by:

- The **failure of auditors to provide adequate warnings** prior to the collapse of a number of banks in the financial crisis.
- **Too few large auditors** providing audit services to the largest companies.
- **The lack of rotation.** Audit firms retain a FTSE 100 client on average for 43 years.
- The **high levels of non-audit work** conducted by the auditor for the same company.
- The apparently heavy **dependence of the regulators and standard setters** on the large audit firms for professional and financial support.

Given the above context, we would like to make the following points relating to the proposed EC Directive and Regulation on audit.

Mandatory rotation

EU proposal. To prevent the same firm being reappointed, firms are to be required to rotate after 6 years. The period before which rotation is obligatory can be extended to 9 years if joint audits are performed. Joint audits are not obligatory but are thus 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).

- Independence and scepticism is vital for audit quality. Rotation is ultimately necessary to ensure a "fresh pair of eyes" and to avoid too cosy a relationship between management and auditors developing. Moreover, where an audit firm knows it will be replaced, it will be incentivised to maintain scepticism as its judgments will be reviewed in detail by the incoming auditor.
- Empirical evidence is inconclusive on rotation's impact for audit quality and costs. There are very few countries that have implemented auditor rotation for long enough to offer robust conclusions. The fact that many countries introduced mandatory rotation, to later abandon it either before it was implemented, or in the early years of implementation does not in our view provide evidence that it does not work.
- Nonetheless, rotation will be associated with a learning curve as new auditors develop their understanding of the business. This is especially true for large and/or complex firms. Audit

tenure must not be so short that it undermines long term audit quality or incentives to take on more complex clients.

- Rotation should also support increased competition, in that it provides the opportunity for entry by non-Big 4 firms.
- Partner rotation does not provide a sufficient guarantee of a 'fresh pair of eyes'. The chances that a new partner will challenge opinions of their predecessor (and the team that stays on) and potentially open the company up to legal challenge are very low. Moreover, action needs to be taken to prevent the engagement partner becoming the firm's Managing Partner / Chairman. There should be a longer, clear water period of e.g. 5 years, as there could be a significant conflict of interest.
- **Proposal:** We support mandatory rotation after two terms. The first term should be 6-7 years, in line with the EU's 8th Directive on Statutory Audit. Where the incumbent wins a second term, this should be a shorter 3-4 years to ensure a maximum audit term of 10 years. A buffer of up to 2 year should be permitted in the event of an unexpected crisis¹. There should be a 'clear water' period of at least 5 years before an auditor can be re-appointed.
- **Alternative proposal:** Audit Committees are required to set a maximum tenure period for auditors (something less than 15 years) to suit their company's complexity and size. This proposal seeks to address the need for Audit Committees to retain the authority to determine the appropriate audit rotation period, but setting a maximum tenure to safeguard shareholders long term interests.

Appointment & tendering

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

- Currently management has too much control over appointment through its proposals to the Board / Audit Committee.
- Shareholders in the UK have the ability to approve the auditor every year through a vote at the AGM. This is an important mechanism for holding the auditor to account. It has, however, been rarely employed.
- Shareholders receive very little information about the quality of the auditor, past interactions with the Board/Audit Committee, criteria used in auditor selection, etc so find it difficult to assess performance.
- **Proposal:** We would like to see a system of mandatory tendering every 6-7 years, combined with mandatory rotation after 10 (see above). We agree that the tender should involve at least two candidates (excluding incumbent) to ensure genuine competition and to open the market to new entrants. We do not feel the EC should go as far as requiring that a smaller auditor is

¹ The EC estimates the additional cost for mandatory rotation every 6 years for companies with a market capitalisation of more than €100m will be no more than €150,000.

involved in the process. The selection and appointment process needs to become more transparent for shareholders.

- Note: We have concerns that the two year minimum appointment would potentially undermine an important shareholder right in the UK: namely, the right to re-appoint the auditor annually.

Non-audit services

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

- Non-audit work introduces a potential conflict of interest within the audit company, especially where the non-audit work is more profitable than audit work.
- **Proposal:** Auditors should be permitted to undertake audit related work, but we favour restrictions on such work for audit clients combined with a requirement that where the value of non-audit work rises above 50% of the audit work, (perhaps because the audit has a particular expertise in this area of non-audit work), the Audit Committee must select a new audit company at the next tender.

Audit reports

EU proposals. Two pages of disclosures are proposed for the audit report within four pages or 10,000 characters (Article 22 of the Regulation).

- Setting a numerical target for the report is too prescriptive.
- **Proposal:** We would like to see a fuller audit report that draws attention to key areas of judgment, estimates, any weaknesses in the financial system, assumptions underlying fair value estimates, any disagreements with management, etc.

Audit committees

EU proposal. Every PIE to have an audit committee. Audit committees strengthened with a majority of members independent and at least one member with competence in audit and one other in accounting and audit (Article 31 of the Regulation).

- **Proposal:** We support having two members with some auditing/accounting expertise on Audit Committees at large cap firms.

EU-wide ISAs

EU proposal. Audits throughout the EU carried out in accordance with ISAs, enhancing audit quality and supporting the provision of EU-wide audit services (Article 20 of the Regulation).

- We have concerns that ISA's will lead to more compliance driven audits tied to IFRS, and reduce auditors' duty to make judgement calls to present a 'true and fair' view of the company's health (as required in the 4th and 7th Accounting Directives)².
- We also have concerns over the independence of the standards setter, IAASB, given its strong dependence on the professional bodies and Big 4 for its funding and support.

² See Richards, I. "Undermining the Statutory Audit: the damaging effects of adopting IFAC-IAASB standards on auditing (ISAs)". June, 2005

- **Proposal:** Rather than extending the coverage of ISAs, the EC should investigate whether IFRS is delivering accounts that provide a “true and fair” view as required under 4th and 7th Accounting Directives, and therefore can ensure proper long term stewardship by management and shareholders.