



Consultation on audit firms providing non-audit services to listed companies that they audit

APB discussion paper

***Response by the
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Private and confidential

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Introduction

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991 as a voluntary association of local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum's 50 members currently have combined assets of over £80 billion.

LAPFF considers audit to be the third line of defence against malpractice: the first two being the integrity of the directors and management and the company's internal governance. The issue of whether and how audit independence can be maintained when non-audit services are provided is crucial to address. We consider that the rigour and independence of the audit needs to be given great attention by analysts, regulators, investors, and other third parties.

In January 2007, LAPFF reported to members its overall agenda on audit practices and reporting and adopted a monitoring policy to enhance its focus on audit committee best practice. This agenda was a result of the governance concerns over various developments in the audit profession. Since then LAPFF has focused on audit committee best practice by undertaking detailed research on companies reporting of audit committee activities and on reporting their policies for awarding non-audit work. This has subsequently been used as a basis for engaging with companies which demonstrate poor practice in these areas.

The Forum finds it difficult to accept that audit firms can retain full independence if at the same time they are providing consultancy services to companies. Where there are commercial interests at stake, shareholders are justified to question the ability of auditors to confront directors on difficult issues.

LAPFF considers the following actions are required;

- A prohibition of non-audit services by the audit firm that undertakes the statutory audit.
- The prohibition should be reflected by amendments to the Auditing Practices Board's (APB) Ethical Standards, to the Guidance on Audit Committees¹ and to the Combined Code².

The Forum has taken the opportunity to provide our view on the following consultation questions, which we consider relevant to our activities.

¹ FRC "Audit Committee Guidance", October 2008

² FRC, the Combined Code, June 2008

1. (a) Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?

1.1. According to the Financial Reporting Council (FRC), the primary objective of an audit of the financial statements “is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly”³.

1.2. To reach this objective the Auditing Practices Board (APB) has adopted its view on auditor’s independence and objectivity, set out in the ‘Ethical Standards for Auditors’ issued in December 2004.

1.3. The Forum supports this objective and considers that the independence of the auditor is of most importance to shareholders, both in respect of individual companies and in terms of audit’s public policy function of ensuring investor confidence in financial reporting.

1.4. The Forum concurs with many of the responses to the Treasury Select report⁴ calling for improvements in the confidence in the independence of auditors. In particular that:

- There is a conflict of interest for auditors providing non-audit services to companies for which they provide audit services.
- A conflict of interest occurs when the auditor provides consultancy services for the management at the same time as it undertakes an audit on behalf of the shareholders.
- The auditor in this case cannot be truly independent from the management since other commercial interests can compromise auditors in their ability to confront directors on difficult issues.
- The current ethical guidance on objectivity within the auditing profession is not sufficient to prevent significant concern being raised.

1.5. It is interesting to note that financial audits are the only kind of audit in the world that permits an auditor to also act as a consultant or advisor at the same firm⁵.

³ House of Commons Treasury Committee; Banking crisis: reforming corporate governance and pay in the City; Ninth Report of Session 2008-09; 15th May 2009.

⁴ House of Commons Treasury Committee; Banking crisis: reforming corporate governance and pay in the City; Ninth Report of Session 2008-09; 15th May 2009.

⁵ House of Commons Treasury Committee; Banking crisis: reforming corporate governance and pay in the City; Ninth Report of Session 2008-09; 15th May 2009.

1 (b) Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality?

1.6. Richard Fleck, Chairman of the APB⁶ quoted the Enron case in 2002 as the starting point for the debate on auditors' suitability of providing non-audit services to companies they audit.

1.7. Since then, there have been different developments but it is debatable as to whether these have been enough and the recent financial crisis has shown that these developments have not been sufficient to protect shareholders.

1.7.1. The Treasury Select Committee's report⁷ states that auditors approved banks' financial statements shortly before those same institutions failed.

1.7.2. The majority of cases of the failed UK-listed banks had paid considerable fees to their auditor for non-audit work⁸.

1.7.3. LAPFF considers that this practice has affected audit quality.

2. If you do consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors please identify which non-audit services are of concern. Please give the reasons for your view.

2.1. Regulations for companies regarding the disclosure of non-audit work were updated in 2005⁹. These regulations require that the amount of non-audit services should be disclosed under ten headings in the notes to the annual accounts.

2.2. LAPFF considers this a step towards better governance but we consider that companies should disclose in the audit committee report the policy for awarding non-audit services to auditors. We do not consider it sufficient simply for the committee to disclose that the company has a policy on non-audit work; the practicalities surrounding the awarding of it should also be disclosed. Therefore, this policy should identify which non-audit services the external auditors are prohibited from providing and a process by which other non-audit services are approved.

⁶ APB PN 113

⁷ House of Commons Treasury Committee; Banking crisis: reforming corporate governance and pay in the City; Ninth Report of Session 2008-09; 15th May 2009.

⁸ The Observer "Investors go to court to call the sleeping audit giants to account", 25th October 2009.

⁹ The Companies (Disclosure of Auditor Remuneration) Regulations 2005 (Statutory Instrument 2417) which apply for financial years beginning 1 October 2005 and thereafter.

- 2.3. From our research, companies' audit committee reports generally have limited disclosure on which non-audit services the auditor has provided during the year. Hence our commitment to engage with companies to improve disclosure on a policy for awarding non-audit work
 - 2.4. In order for shareholders to be able to make a judgement, we consider this policy should include both the broad nature of the non-audit work and specific details of the nature of the work to be undertaken.
 - 2.5. We consider that an auditor that undertakes the statutory audit for a company should only perform this duty and those other services supplied pursuant to legislation. Other professionals should undertake all other non-audit work.
 - 2.6. Among the current non-audit services auditors currently undertake, we consider taxation and tax advice to be potentially one of the most controversial ones given the scope for reputation risk. In addition, we consider a company's auditors should not undertake internal audit functions for the same company they audit.
 - 2.7. LAPFF concern over auditors providing non-audit services has been reflected in voting advice for some company AGMs to oppose the election of auditors. Voting alerts have been issued by the Forum where non-audit fees substantially exceed audit fees.
 - 2.8. There is at least one member of the Forum whose concern is such that the fund does not support the election of auditors if there are any non-audit fees incurred from a client firm.
- 3. In the light of your answers to questions 1 and 2, do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit? Please give reasons for your view.**

3.1. The purpose of the APB's 'Ethical Standards' is to "provide professional accountants with guidance on how to meet its obligations to take into consideration the public interest and to maintain the reputation of the accountancy profession". We note that failure to follow the Ethical Standards may lead to a professional accountant becoming liable to disciplinary action as outlined in the Disciplinary Bye-laws 4, 5, 6 and 6A¹⁰.

3.2. The Forum understands that it is the intention of the APB, following recommendations from the consultation, to possibly amend the Ethical Standards. We welcome this move and hope that the consultation will lead to a prohibition of the use of non-audit services by auditors who perform the statutory audit in the firm.

¹⁰ APB, Ethical Standards for Auditors, April 2008

3.3. Additionally, we would like to see the prohibition of non-audit services incorporated as a requirement in the Combined Code and in the FRC's Guidance on Audit Committees. Audit committees are regulated through the requirements set out in the Combined Code and they need to comply or explain how they have fulfilled these requirements. They are further recommended to follow best practice which is set out in the Guidance on Audit Committees.

3.4. We think that enforcing a prohibition for both the auditor and for the audit committee will achieve a better result.

4. If you think that there should be a change in the current arrangements, would you advocate:

- o **Complete or more extensive prohibitions on the provision of non-audit services by accounting firms to their audit clients within the Ethical Standards for Auditors;**
- o **The imposition of other requirements through the Ethical Standards for Auditors (and if so which);**
- o **More active corporate governance – e.g. so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee;**
- o **Better (and more extensive) disclosure in financial statements.**

Please provide reasons for your views and any suggested solutions.

4.1. We would welcome a change from the current arrangements and we consider there should be more extensive prohibitions on the provision of non-audit services by accounting firms to their audit clients.

4.2. We have so far engaged with audit committees for better and more extensive disclosure requirements in the annual reports and for stricter requirements in the current regulatory framework.

4.3. Our underlying purpose for this engagement is the wide-spread lack of real transparency in much of the financial sector worldwide. We consider there is a need, which is even more important in the current economic climate, for rigorous oversight by audit committees on the financial regulation and control of companies.

4.4. The Forum considers companies can demonstrate commitment and engagement to addressing risks to the internal and financial controls of the company to their shareholders by providing transparency in reporting including reassurance over the rigour of the processes involved in awarding non-audit work. When this reassurance is provided, shareholders are better placed to understand and manage the risks of their investments.

- 4.5. The ability to press for improved disclosure on non-audit fees has been limited due to the lack of enforcement mechanisms in the regulatory framework. It seems audit committees respond better when enforced through the requirements set out in the Combined Code and by the Guidance on Audit Committees.
- 4.6. This can be illustrated by paragraph 2.2 of the Guidance on Audit Committees which requires that companies should have a policy in place for the provision of non-audit services by the auditors.
- 4.7. According to LAPFF research in 2008, most FTSE100 companies state that they have such a policy in place.¹¹ However, many fail to disclose what this policy is in practical terms. The Forum's more recent engagement with companies on audit issues supports this view.
- 4.8. LAPFF focussed on FTSE 350 companies with poor audit committee reports and those with inadequate disclosure on policies for awarding non-audit work in order to encourage better reporting and transparency.
- 4.9. Responses by companies to letters sent by the Forum regarding disclosure of policies on awarding non-audit services to auditors show that there were two main reasons for inadequate disclosure.
- The first reason is that companies may have a policy but they do not disclose it in the annual report. Paragraph 2.2 of the Guidance on Audit Committees requires companies to have a policy but fails to specify where the policy should be disclosed. LAPFF considers that it should be a requirement for companies to disclose in the annual report a policy on awarding non-audit services to auditors. We do not consider it sufficient simply for the committee to disclose that the company has a policy on non-audit work; the practicalities surrounding the awarding of it should also be disclosed.
 - The second reason for inadequate disclosure of such a policy is misinterpretation of what the policy should consist of. LAPFF considers that this policy should identify which non-audit services the external auditors are prohibited from providing and a process by which other non-audit services are approved.
- 4.10. Our research shows the difficulty in compelling companies to improve disclosure in their annual reports. Increased disclosure requirements set out in the Ethical Standards and the Combined Code are one step towards better governance but we consider an outright prohibition to be the ultimate goal.

¹¹ http://www.lapfforum.org/members/misc/11_15_ImproveQltAuditComm.pdf

5. In setting the standards relating to auditor independence, do you believe regard should be had to the perceived benefits that are derived by companies from the provision of non-audit services by their auditors? If your answer is yes, please provide specific examples of these benefits and indicate the magnitude of any cost savings that arise.

5.1. We acknowledge that provision of non-audit services by the auditors may provide cost savings for companies but we do not consider these are sufficient to compromise the importance of the independence of the auditor.

5.2. Whilst there may be cost savings for companies, non-audit services are also income generating activities for the accounting industry and especially for “the Big Four”.

5.3. The accounting industry has been successful in its continuing campaign to ensure that audit firms are not prohibited from providing other services to audit clients. The industry would lose hundreds of millions of pounds if tougher restrictions on the services they can sell to listed companies whose accounts they audit, are put in place. We note that in 2008, the “Big Four” accounting firms generated about £530 million in fees from auditing Britain’s 100 biggest companies and made a further £380 million from other services to those clients¹².

5.4. According to the FRC¹³ “the Big Four” still dominate the market. As at August 2009, 98% of the FTSE 100 had appointed one of the big four as their auditors. We do not consider it appropriate that so few companies should control the market. A prohibition of non-audit services would increase the competition between auditing firms and give smaller auditing firms a chance to increase their market share.

6. Are there any other views that you would like the APB to take into account?

6.1. The Forum observed from a recent audit quality forum debate that the discussion seemed to be dominated by the views of the audit chairs and auditors present, who were not in favour of the prohibition of non-audit services provided by the auditors. The investor view was more thinly represented but a key point made in different ways, was around the fact that an audit’s function is to provide assurance to shareholders. If there is pressure from investors to prohibit non-audit services provided by auditors, particular attention should be paid to their views. The audit committee and chair may decide what is good for the company, but not necessarily what is in the best interest of shareholders.

6.2. The Forum considers there are other mechanisms that can be considered to hold companies and audit committees to account. For example, there should be a

¹² http://business.timesonline.co.uk/tol/business/industry_sectors/article6863783.ece

¹³ [FRC “Choice in the UK Audit Market - Fourth Progress Report” ; Oct 2009 p. 20](#)

statutory shareholder vote on audit committee reports. Investors would then be able not only to review the quality of audit committee reporting on the policy and method of awarding non-audit work, but to send a signal to a company where this is perceived as inadequate.

- 6..3. As part of its ongoing work relating to public policy, LAPFF has also recently made submissions to both the Walker Review and to the Financial Reporting Council. LAPFF's policy engagement reflects its desire to ensure that shareholders are meeting the challenges arising from the financial crisis, and a determination to achieve real reform in a number of areas. The Forum has argued that it is time to consider annual election for all directors. If audit committee chairs were to face annual election, this would provide far greater and more immediate accountability for the role the committee has played over the year in challenging company auditors and ensuring that a truly independent and challenging audit is achieved for the benefit of investors.