

Ms Hazel O'Sullivan
Project Director
Auditing Practices Board
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Dear Ms O'Sullivan

APB CONSULTATION ON AUDIT FIRMS PROVIDING NON-AUDIT SERVICES

I am writing to comment on the above consultation paper on behalf of rpmi Railpen Investments, the investment monitoring arm of the Railways Pension Trustee Company Limited, the corporate trustee of the UK railway pension funds with approximately £18 billion of assets under management and 350,000 beneficiaries.

We are long standing supporters of better corporate governance and consider external audit to be one of the pillars of good governance. It follows that we have an interest in robust external audit as a major pension fund investor in listed companies and we believe that the provision of non-audit services has potential ramifications in terms of audit independence and quality. We remain concerned about the absence of choice in the market for audit services and wish to encourage higher standards of audit quality. We consider that shareholders have much to gain from greater scrutiny of the range and quantity of services being provided by the audit firms and we welcome the opportunity to respond to your consultation.

We were consulted in the drafting of the responses prepared by the IMA and the NAPF and while in broad agreement with their responses, we would like to add our own specific comments below:

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?

Yes, though this is in part a matter of perception in that the significant revenues generated and the nature of the services could lead the auditor to identify with the interests of management rather than investors. This is a particular risk when the fees for non-audit services become significant in relation to the audit fee and when the relationship between the client and the auditor becomes too close such that the latter's impartiality is affected. Hence we believe it is important that such services are regulated and, although the current regulatory framework has generally been effective and does not need of major change, we believe there are some specific situations where concerns of investors could be addressed.

We also feel that audit committees need to be more robust in their assessment of the services provided by their auditors and more transparent in how they describe that process to shareholders. It is fair to say that reporting by the audit committees is too often boilerplate and uninformative in its approach. There is also considerable lack of clarity about what constitutes a non-audit service. We consider that investor confidence would be enhanced by more detailed analysis of the nature of the non-audit services provided and the associated fees, and if audit committees reported more effectively on the reasons for such services.

(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?

We note the reference in the IMA response to the case of MG Rover and its parent company, Phoenix Venture Holdings, in which the non-audit fees were a very high multiple of the mainstream audit fee both in relative and absolute terms, and accounted for well over 90% of the total fees over a three year period from 2002 up to the collapse of the group in 2005. We appreciate the case is currently under investigation by the Accountancy & Actuarial Discipline Board in relation to services provided to the group by its external auditor and whilst we accept that it is inappropriate to pre-judge the outcome, the high level of non-audit fees is a significant factor that reinforces our earlier comments in 1 (a) above on perceptions.

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.

We support the IMA argument that there are certain services where the conflict of interest is extremely material such as restructuring. While most are identified in the Ethical Standards, there remains an onus on firm and client to assess on a case by case basis whether an appointment would be appropriate.

It is worth observing that the fees in the MG Rover case were high, they did not breach the threshold set by Ethical standard 4 which sets out percentage limits by reference to the audit firm's annual income of 10% for a listed company client and 15% for other clients. This suggests that in addition to the existing limits, it may be worth looking at a limit set by reference to a multiple of the audit fee which should be formally approved by the audit committee and properly explained in its report to shareholders.

We are concerned by the provision of both internal and external audit services by the same firm which has obvious implications for audit independence in that the external audit firm will in effect audit its own work and may be taking on management functions. The recent Rentokil case provides an unwelcome precedent in this respect which damages public confidence and we hope that it is thoroughly reviewed by the appropriate regulatory authorities.

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?

We believe that the current regulatory frame work is generally appropriate and note the welcome trend cited in the consultation paper that the provision of non-audit services to listed audit clients has fallen significantly since 2002. However, we feel that this should not be cause for complacency and consider that investor confidence would be significantly enhanced by more detailed analysis of the nature of the non-audit services provided and the associated fees, and if audit committees reported on the reasons for commissioning such services.

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

- **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;**

We do not favour the outright prohibition of non-audit services by accounting firms to their audit client but support some degree of restriction. We consider that the existing framework of

prohibition is largely adequate. However, we feel that the provision of internal audit services should be more strongly discouraged.

- **The imposition of other requirements through the Ethical Standards for Auditors (and if so which);**

Please see our comments above on the Rentokil case. We are concerned that Rentokil's auditors may be in effect auditing their own internal work and taking on management functions. Although paragraph 44 of ES 5 prohibits the provision of internal and external audit services in certain circumstances, the Rentokil case indicates that this may need to be strengthened. We also consider there should be better disclosure by audit committees on why they consider such an arrangement is of benefit to the company and its overall control environment.

We also share the IMA's general view that the existing ethical standards could be clearer and easier to understand – particularly in explaining the different types of non-audit services that exist and why it can make sense to obtain the service from the audit firm.

- **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;**

We would expect there be effective oversight of the type and quantum of services being purchased from an audit firm, to ensure compliance with best practice as set out in Combined Code provisions C.3.2 and C3.7. This should be routine in most companies and encouraged where it is not.

- **Better (and more extensive) disclosure in financial statements.**

We believe that better and more extensive disclosure will do much to improve confidence in a company's approach to addressing the problem. Although existing rules require disclosure of non-audit fees, it is worth making a distinction between bare compliance and transparency. In too many cases disclosures in the notes to the accounts are not supported by sufficient explanation. Audit committee reports are often uninformative and do not make an adequate attempt to explain the position. This suggests that requirements could be improved and the information disclosed made clearer.

We would expect companies to provide enhanced disclosure about the quantity and type of services provided and the rationale for employing the audit firm rather than an outsider. This could be incorporated into a wider statement in which the audit committee comments on its approach to assessing its relationship with the company auditor.

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.

We consider the standards relating to auditor independence are an important safeguard and whilst there may be benefits in the provision of non-audit services for the effectiveness and efficiency of the audit, these benefits should not compromise the standards on independence. The onus is on the company to assess (then explain to shareholders) whether the benefits of taking a service from its auditor outweigh the drawbacks.

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

No.

We hope that these observations are helpful and look forward to the APB's proposals in the light of this consultation.

Yours sincerely

Frank Curtiss
Head of Corporate Governance