Restoring trust in audit and corporate governance

Nest's response to the consultation

About us

Nest was established in 2010 as part of the auto enrolment programme to help people save for retirement. Unlike any other pension scheme in the UK, Nest has a legal obligation to accept any employer that wishes to use us to discharge their auto enrolment obligations. Over 870,000 employers have signed up to use Nest.

Over the last decade, Nest has grown to be one of the largest pension schemes in the UK. We are operating at scale as a high quality, low cost pension scheme helping over 10 million members save for their retirement. Many are low to moderate earners who may be saving into a pension for the first time. A typical Nest member earns around £20,300 per year and nearly half our members are aged under 35 years old.

Nest is built around the needs and behaviours of our members, from our approach to responsible investment to our focus on customer service. We now occupy a place in the market as a major Master Trust, helping to drive up standards and best practice across the industry. Nest has great potential for delivering pensions to mass market consumers for many years to come, leveraging our scale to deliver value through the combination of low costs, our market leading investment strategy and modernised services all overseen by strong trustee governance.

Response

Nest is pleased to have the opportunity to respond to the consultation paper 'Restoring trust in audit and corporate governance'.

1 Engagement to date

We have engaged throughout the audit market review process via meetings and responses to:

1. Competition and Markets Authority's review of the statutory audit market October 2018 and update paper, April 2019. In addition to written responses we met in-person with the CMA twice during the consultation period. We were especially encouraging of the CMA re-introducing its earlier proposal of a shareholder vote on structuring the overall external audit. We believe this to be such an important element of strengthening accountability and investor involvement. We fully support BEIS actioning the CMA proposal that pre-dates its 2018 paper.
2. Kingman Review, December 2018 – both the initial consultation and the follow-on questions.

3. Brydon Report, December 2019.

2 Scene set: the big picture

We expend significant resource on audit and assurance and have remained engaged throughout the review process because the investment actions we take and the reporting we make to our members have many intersections with audited information. We use audited information to:

◊ Make investment decisions on behalf of our members.
◊ Inform our approach to stewardship of the assets and instruments we hold on behalf of our members. In the absence of stewardship by investors like us there is nothing to bind listed companies to the Corporate Governance Code and make them accountable to it.
◊ Vote to appoint directors to represent us, vote significant items, make judgements on corporate actions, and to form perspectives as we engage with companies.
◊ Support decisions around non-equity investments - for example covenants, provisions and options on debt and loan instruments.
◊ Hold ourselves to our net zero climate change ambition.

Below we highlight key areas of support for the consultation's themes.

3 Summary of our key support

Colouring in the detail

The consultation document performs a broad sweep of the three reviews mentioned above. Consequently, the document leaves many unknowns around what will happen when we drop into the detail – how the recommendations will be operationalized and how they should be described in legislation. The FRC (ARGA) and BEIS will need to execute on several work packages simultaneously, and resource at the right level. We have no doubt about the ability of both organisations to achieve the right level of detail in a consensual manner to get the work through legislation and into standards.

Greater shareholder engagement with audit

We believe strongly in standard setters empowering investors. Standard setters increasingly expect to see clear evidence of actions by investors to reduce externalities when looked at in the round, as well as evidence of investors' taking an active role in helping create sustainable and positive financial change. Investors have to be empowered if they are to deliver what standard setters and the public expect from them. We believe an advisory vote on audit and assurance policy to be a welcome and significant step-forward. We have supported the introduction of a vote on audit and assurance policy since first proposed by the Competition Commission, and have communicated our support ever since. A shareholder vote offers significant reach and impact because most investors - large and small, index and active, international and domestic – vote. We also support shareholders having the ability to ask auditors to review key areas of concern, while cognizant that far fewer investors engage consistently company-by-company.

On company reporting, we would like to see a level of assurance on a set of:

◊ Climate-related and sustainability reporting
◊ Internal controls statements on financial reporting
◊ APMs and KPIs linked to executive remuneration

We believe the FRC is already giving consideration to some or all of the three areas above.

Rigorous audit process

We support strengthening the internal control framework, and in our response we highlight the apparent benefits of SOX-type regulation to the US. We also welcome the greater obligations on auditors around fraud detection.

Contrary to the perspective taken in the consultation, we do support the audit of APMs and linked KPIs used to determine executive remuneration. There is sufficient grey area around their calculation and sufficient importance in determining executive remuneration to warrant these coming within scope of the external audit.

We support replacing the going concern statement and viability statement with a resilience statement.

We agree that the scope of the audit should expand to include additional disclosures on sustainability and climate change metrics.

We do not have strong views on managed shared audit, through we can see that the practicalities of how that will work is an important area.

Corporate governance proposals

Within the broad spectrum of views about the types of companies to include in the definition of PIEs, we strongly support extending the definition to include larger private companies. Institutional investors like us are expected to increase investment allocation to such companies in the future, and the illiquidity of such investments demands a similar level of audit and assurance as with publicly listed companies. Without that, the investments products of members, customers, and policyholders will encounter additional, and undiversifiable, risk.

We support the ambition that listed companies recover bonuses or share awards from executive directors if they have failed to protect customers' and employees' interests. This is an area where dropping into the detail could take a while to work through.

We support ARGA becoming responsible for approving the auditors of PIEs.

We are less sure that the benefits of additional dividend related regulation and disclosure will outweigh the costs – at least for investors like us. To put the additional UK dividend related requirement in perspective, our portfolio is multi asset and international, buy-backs are as important as dividends, many companies pay low or zero dividends, and companies that payout close to all their net profit are very few indeed. Overall, the additional information proposed is not that impactful or beneficial to Nest, however we can see that it could be in exceptional circumstances, where a company is small, close to insolvency, and has a large block holder with the power to take distributions from a company at an unsustainable rate. That has happened in the past and continues to remain a possibility in a handful of instances.

3.1 Below we provide further feedback to select individual consultation questions. We do not express an opinion on all questions. We feel some are not within our scope, and others we skip because we do not have a particular view or our view is pointing in the same direction as the consultation question.

4 Our response to the Review's questions

5 Chapter 1 – The Government's Approach to Reform

6 Q1: Should large private companies be included within the definition of Public Interest Entity (PIE)? Please give your reasons

We believe the right approach is to bring large private companies within scope.

Nest invests so that our members retirement savings reflect the gains from broad economic growth. Both publicly listed companies and private companies contribute to that growth.

A myriad of intersections connect public and private companies, inexorably linking their ability to succeed and sustain their performance. Our investment interest is the health and sustainability of that ecosystem.

Presuming large private companies are included within the definition, we believe similar governance, internal control, and audit standards should apply to both types of company. To us this feels the right way to improve how the whole capital market operates, create sustainable wealth, and deliver long-term benefits to end investors. Our members will be better protected, the UK should be a more attractive location for international capital, bringing benefit to the whole corporate sector.

We do not believe our membership would make a distinction between corporate distress at a public listed company or private company whose securities we hold in our portfolio, so neither should the definition of PIEs.

We also recognise that economy-wide targets such as Net Zero require all companies to adapt and evolve regardless of their type of incorporation.

Our views align with the November 2020 Asset Management Taskforce report on placing stewardship at the heart of sustainable growth.

7 Q2: What large private companies would you include in the PIE definition: Option 1, Option 2 or another? Please give your reasons.

We believe Option 1 is the right approach. The definition has the benefit of greater inclusiveness – encompassing size measured by number of employees, total assets, and revenue. The definition benefits from consistency for the same is used in the Wates corporate governance principles for large private companies.

Government will need to ensure ARGA is sufficiently resourced to provide effective oversight of the more expansive scope for PIEs.

8 Q3: Should AIM companies with market capitalisation exceeding €200m be included in the definition of a PIE? Please give your reasons.

We support AIM companies with market capitalisation exceeding €200m being included in the definition of a PIE. While the AIM market is not significant for medium and large pension funds like Nest, the market is important to the wealth management and private client sectors, particularly so because investments in AIM companies qualify for Business Property Relief. More cautious individual investors are more likely to allocate investment to a spread of AIM companies than other inheritance tax exempt vehicles such as EIS and SEIS for inheritance tax purposes. The cautious risk appetite of such investors could be a reason for the definition proposed.

9 Q4: Should Government give newly listed companies a temporary exemption from some of the new reporting and attestation requirements being considered for Public Interest Entities?

We have some sympathy for a gradualist approach towards smaller companies that have recently fallen within scope of the PIE definition irrespective of whether they are listed or not. We would have less sympathy for a gradualist approach where an already large overseas company chooses to list in the UK. The UK is an attractive destination for international financial capital because companies within the UK jurisdiction give investors' confidence due to meeting high quality financial reporting, governance, and internal control.

We do appreciate the balancing act required, as articulated in Lord Hill's review into the UK listing regime.

10 Q6: Should the Government seek to include large third sector entities as PIEs beyond those that would already be include in the definitions proposed for large companies? If so, what types of third sector entities do you believe should be included and why?

We have in mind Universities and Housing Associations. Both are long-term institutions, issue debt, are invested in by long-term institutional investors like us, and our members would benefit from improved reporting and disclosure.

11 Q9: How would an increase in the number of PIEs impact the number of auditors operating in the PIE audit market?

Our understanding is an increase in the number of PIEs will not place significant pressure on the number of audit firms. Our belief is that the audit market is already quite segmented. The "big four" dominate the medium and large public listed company segment, while other audit firms have a high share of the public sector audit segment, small company audit segment, or third sector entity audit segment. Consequently, more PIEs is likely to mean more work for non-big four audit firms who are better-positioned, and have the capacity to grow further.

12 Q10: Do you agree that the Government should provide time for companies to prepare for the introduction of a new definition of PIE?

Yes

13 Q11: Do you agree that the Government should seek to offer a phased introduction for a new definition of PIE?

Yes

14 Chapter 2 – Directors' Accountability for Internal Controls, Dividends and Capital Maintenance

15 2.1 – Stronger Internal Company Controls

Q12: Is there a case for strengthening the internal control framework for UK companies? What would you see as the principal benefits and disbenefits of stronger regulation of internal controls?

Based on evidence from SOX regulation in the US, we strongly support strengthening the internal control framework. The principal benefits of that regulation appear to be:

A reduced cost of capital for signatory firms.

A shortening in management commentary and the extensiveness of reporting.

An increase in internal control after the regulation was put in place that likely would not have occurred had the regulation not been there. Causation seems to run from CEO and CFO attestation to stronger internal control.

Cost does not appear large in relation to market capitalization.

16 Q13: If the control framework were to be strengthened, would you support the Government's initial preferred option (Table 2)? Are there other options that you think Government should consider? Should external audit and assurance of the internal controls be mandatory?

We support the elements mentioned in the preferred option – which draws from the Sarbanes-Oxley regime in a manner that is proportionate and in line with the UK's existing provisions.

We believe operational and financial controls should be within scope of internal control.

We would prefer mandatory external audit and assurance extended to all PIEs. This could phase-in, with large private companies treated no differently to their public listed counterparts.

17 2.2 – Dividends and Capital Maintenance

18 Q15: Should the regulator have stronger responsibilities for defining what should be treated as realised profits and losses for the purposes of section 853 of the Companies Act 2006? Would you support either of the two options identified? Are there other options

which should be considered? What should ARGA consider when determining what should be treated as realised profits and losses?

Dividends cannot and should not be paid from shareholder capital. That much is already in law. Dividends are paid from profits, raising the technical question - what profit figure should be used to determine what could, in-principle, be paid-out as dividends? There is some ambiguity to the current definition, and firming-up the definition of realised profit feels like that is within-scope of ARGA. Consequently, we support option 1 - to give ARGA a duty to prepare guidance on what should be treated as realised profits and losses in accordance with generally accepted principles prevailing at the time.

19 Q16: Would the proposed new distributable profit reporting requirements provide useful information for investors and other users of accounts? Would the cost of preparing these disclosures be proportionate to the benefits? Should these requirements be limited to listed and AIM companies or extended to all PIEs?

Nest invests in companies around the world, pretty much pro-rata with the size of each country's capital market. To put the additional UK dividend related requirement into that perspective, our portfolio is multi asset and international, buy-backs are as important as dividends and the former can come from reserves - not current profits, many companies pay low or zero dividends, and companies that payout close to all their net profit are very few. Overall, the additional information is not going to be that impactful or beneficial to Nest.

A more interesting area – one that is corporate governance related - is the particular definition of profit used by the board when awarding performance related remuneration. We would not be favourable of performance linked remuneration calculated on unrealised profit – which loops back to ARGA firming-up the definition.

20 Q17: Would an explicit directors' statement about the legality of dividends and their effect on the future solvency of a company be effective in both ensuring that directors comply with their duties and in building external confidence in compliance with the dividend rules? Should these requirements be limited to listed and AIM companies or extended to all PIEs?

If BEIS determines that a statement is required, we believe the scope should encompass smaller companies. In a small company there is more chance of there being a large block holder with the power to take distributions from a company at an unsustainable rate.

21 Q18: Do you agree that the combination of recently introduced Companies Act section 172(1) reporting requirements along with encouragement from the investment community and ARGA will be enough to ensure that companies are sufficiently transparent about their distribution and capital allocation policies? Should a new reporting requirement be considered?

Based on the companies that Nest invests in and our global approach to investment, our opinion is that a new reporting requirement on distribution and capital allocation over and above what is reported in current financial statements should not be prioritized among the other important things to get done.

22 Chapter 3 – New Corporate Reporting

23 3.1 – Resilience Statement

24 Q19: Do you agree that the above matters should be included by all companies in the Resilience Statement? If so, should they be addressed in the short or medium term sections of the Statement, or both? Should any other matters be addressed by all companies in the short and medium term sections of the Resilience Statement?

We support the introduction of a Resilience Statement to replace the Going Concern and Viability Statements. We expect ARGA would want the short-term statement to be within scope of the external audit. How assurance of the medium-term and long-term sections is achieved could be left for companies to choose and articulate in the Audit and Assurance Policy.

We envisage ARGA will want to further consult with stakeholders about matters to be addressed, mindful that any fixed list drawn-up may quickly become outdated.

25 Q20: Should the Resilience Statement be a vehicle for TCFD reporting in whole or part?

Our view is that the Resilience Statement and TCFD reporting serve two separate objectives and should be reported on independently. The Resilience Statement may wish to link to TCFD reporting.

26 Q21: Do you agree with the proposed company coverage for the Resilience Statement, and the proposal to delay the introduction of the Statement in respect of non-premium listed PIEs for two years? Should recently-listed companies be out of scope?

We agree, and believe a new premium listed company such as a large overseas company listing in the UK, should be in-scope.

27 3.2 – Audit and Assurance Policy

28 Q22: Do you agree with the proposed minimum content for the Audit and Assurance Policy? Should any other matters be addressed in the Policy by all companies in scope?

We agree, mindful that ARGA is yet to develop the detail. We hope ARGA will consider the suitability of assurance to some of the evolving areas of important reporting such as:

- ◊ Internal controls statement relating to financial reporting
- ◊ Resilience statement and other risk disclosures
- ◊ APMs and their KPIs where linked to executive remuneration
- ◊ ESG disclosures, in particular TCFD and sustainability reporting

29 Q23: Should the Audit and Assurance Policy be published annually and subject to an annual advisory shareholder vote, or should it be published and voted on at least once every three years?

We are delighted the original CMA proposal has re-surfaced.

In 2013, the Competition and Markets Authority (formerly the Competition Commission) published a number of remedies within its report, ‘Statutory audit services for large companies market investigation – A report on the provision of statutory audit services to large companies in the UK’.

Remedy 4 included a recommendation to introduce an advisory vote for shareholders. The CMA considered that introduction of a vote 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.

Nest strongly supported the CMA proposal then and we continue to now. Over the years we have consistently communicated such. At the time the FRC considered that shareholders already had sufficient rights to express their opinion on the external audit and felt the additional step was unnecessary. We raised the issue of re-considering the idea of a new vote in our engagement during the 2018 CMA, 2018 Kingman, and 2019 Brydon reviews. These reviews have taken that onboard, and we are pleased the FRC is now supportive of a vote.

Limited existing provisions for engagement on audit incentivize investor passivity. The advisory vote proposed empowers investors, and will encourage the desired behavioural change within the external audit process. Investors will develop their knowledge base, build the expertise, and get under-the-hood of audit because they now get a say on how they want external audit and assurance to be structured at a high level – including scope, thresholds, tendering, additional areas investors would like the auditor to look.

Past evidence shows that once investors have the chance to vote, behavioural change follows. A recent example is the vote on pay policy and the now extensive engagement between investors and remuneration committees on that.

Nest supports the proposal for an advisory shareholder vote every three years. As with the vote on remuneration policy, an annual vote could be required if there is significant change to audit and assurance policy.

30 Q24: Do you agree with the proposed scope of coverage and method for implementing the Audit and Assurance Policy?

Yes

31 Chapter 6 – Audit Purpose and Scope

32 6.1 – The Purpose of Audit

33 Q35: Do you agree that a new statutory requirement on auditors to consider wider information, amplified by detailed standards set out and enforced by the regulator, would help deliver the Government’s aims to see audit become more trusted, more informative and hence more valuable to the UK?

Yes

34 Q36: In addition to any new statutory requirement on auditors to consider wider information, should a new purpose of audit be adopted by the regulator, or otherwise? How would you expect this to work?

We agree with the Brydon report

35 6.2 – Scope of Audit

36 Q37: Do you agree with the Government's approach of defining the wider auditing services which are subject to some oversight by the regulator via the Audit and Assurance Policy?

Yes

37 Q38: Should the regulator's quality inspection regime for PIE audits be extended to corporate auditing? If not, how else should compliance with rules for wider audit services be assessed?

Yes

38 Q39: What role should ARGA have in regulating these wider auditing services? Should its role extend beyond setting, supervising and enforcing standards?

ARGA should also provide guidance to support the direction of travel of market practice and pace of development.

39 6.3 – Principles of Corporate Auditing

40 Q40: Would establishing new, enforceable principles of corporate auditing help to improve audit quality and achieve the Government's aims for audit? Do you agree that the principles suggested by the Brydon Review would be a good basis for the regulator to start from?

Yes

41 Q41: Do you agree that new principles for all corporate auditors should be set by the regulator and that other applicable standards or requirements should be subject to those principles? What alternatives, mitigations or downsides should the Government consider?

Yes

42 6.4 – Tackling Fraud

43 Q42: Do you agree with the Government’s proposed response to the package of reforms relating to fraud recommended by the Brydon Review? Please explain why.

We agree. As the detail is developed we hope ARGA will consider Brydon’s additional proposals regarding:

- An open access case study register detailing corporate frauds
- An independent Auditor Fraud Panel similar to the Panel on Takeovers and Mergers

44 6.7 – Audit of Alternative Performance Measures and Key Performance Indicators Linked to Executive Remuneration

45 Q45: Do you agree that the need for specific assurance on APMs or KPIs, beyond the scope of the statutory audit, should be decided by companies and shareholders through the Audit and Assurance Policy process?

In our opinion, the consultation viewpoint does not deliver the best outcome. We believe that APMs and linked KPIs used to calculate executive remuneration need to audited. Auditors could pick-up ESMA’s Guidelines for APMs.

46 Chapter 7 – Audit Committee Oversight and Engagement with Shareholders

47 7.3 Shareholder Engagement with Audit

48 Q58: Do you agree with the proposals and implementation method for giving shareholders a formal opportunity to engage with risk and audit planning? Are there further practical issues connected with the implementation of these proposals which should be considered?

Yes

49 Q59: Do you agree with the proposed approach for ensuring greater audit committee chair and auditor participation at the AGM? How could this be improved?

We agree. As a matter of accountability this feels right to do.

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