STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of hearing with the Association of Financial Markets in Europe held on Friday 29 June 2012

Background

1. The Association for Financial Markets in Europe (AFME) was established in 2009 and was formed by the merger of the London Investment Banking Association and the London side of the Securities Industries and Financial Markets Association (SIFMA). SIFMA remained in existence in the USA and there was a corresponding association in Asia. The three associations come under the umbrella of the Global Financial Markets Association. AFME described itself as the major European trade body for investment banks and securities dealers and people who generally operated in the wholesale financial markets.

2. AFME had around 60 to 70 members. The largest 15 to 20 members operated globally or near globally and had their ultimate holding company and head office outside the UK and typically in the USA, Switzerland or Japan. Most key decisions on audit services were typically made outside the UK including the appointment of auditors and the agreement, at the highest level, on what they would do. AFME members had other factors to consider in addition to the legislative regime of the parent country. For example, a company with a head office in the USA needed to follow the legislative requirements of the USA and those of the local jurisdiction.

Proposal for an EU Regulation

3. AFME explained that although they would keep a watching brief on the Competition Commission's (CC's) investigation into audit services, it was unlikely to have as much impact on its members as the proposed European Union (EU) Directive. AFME had recently made submissions to the European Commission and to key Members of the European Parliament.

4. AFME referred to the note they had submitted to the CC which set out its main concerns about the EU proposal.[1] In particular, it was concerned about the proposal for the compulsory rotation of auditors. It would be happy to return to talk to the CC at a later stage when it was considering recommendations following its investigation.

The nature of audit services required by AFME's members

5. The nature of audit services that were supplied to a large global operation were different to the nature of those services supplied to a relatively simple entity operating in a single country. A defining feature of AFME's members was that they were spread out widely both in terms of product and geography. Therefore the size of any one unit in a particular country was relatively small when compared with the total size of the company. If something had gone wrong with the accounting system or the reporting system in a particular unit and the auditors picked this up, it would be extremely unlikely that the differences would be sufficient to be material at group level. AFME

[1] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/eu_audit_reform_proposals_afme_position_paper.pdf

could not think of an example of a major global operation that had had to change its accounts in a material way because of the actions of the auditor. This contrasted with quite large companies operating in a single country where results had changed because the auditors took a different view of the accounts. This showed that the real value to the company and the shareholders of the audit was not actually telling them that the numbers were right but providing a judgement on the integrity of the control and reporting systems.

6. A very large proportion of the FTSE 350 operations were in one country so they were in a rather different category to AFME's members who were global operators where the largest single market might account for only around 20 per cent or so of their overall business. AFME's members' main interest in the audit process was the integrity and effectiveness of the control systems including whether the numbers were correct in a subsidiary. Incorrect numbers in a subsidiary often meant that something was wrong with the control systems. In order to obtain feedback on the integrity and effectiveness of the control systems several things were necessary: good knowledge by the auditors of how the company worked (this implied not changing auditors too frequently) and good communications within the auditors. For example, companies could ask the local partner of their audit firm to check on the quality of internal control systems when they had reason to suspect something might not be up to scratch. This could be very valuable information. If a different firm of auditors was auditing a local subsidiary, it was very difficult for that type of informal communication to work effectively. This led to companies' strong preference for a single firm of auditors acting globally.

7. In theory, the informal network that some of the second tier audit firms had could provide the same service, but AFME's network was unlikely to be as strong and personal. This was in turn likely to affect the quality of information reported back. The service offered by a global firm of auditors included feedback that would go beyond whether the numbers were correct and whether there were any weaknesses within the control system. If the parent company had concerns about a local subsidiary, it was easier to ask its auditor who had a local presence to investigate and provide an answer on matters such as: whether systems were fit for purpose, whether they were being properly applied and whether the financial people were performing, and whether the policies and procedures were set out in a way that was clear and applicable. By the time any information reached parent-company level, much of the smaller details would have been dealt with locally and it would only be very high level issues that would get reported to the audit committee, beyond reporting if aspects of the control system in a subsidiary needed attention.

8. The complementary parts of the audit package, including informal feedback that the Big 4 were able to provide due to their global presence, was omitted from publicly available reports. Shareholders might want to ask for some reassurance on the actions of the Chief Executive (CE) and Chief Financial Officer (CFO) but that was a slightly different matter and much more likely to reach the public domain. For the main AFME members, it was not practical to have that type of hands-on oversight because AFME's members were too big and diverse. AFME's members therefore needed a hierarchical management structure to ensure that their control systems were working and their staff were performing. AFME's members typically employed a chain of command structure whereby two to six layers of management might lie between the Board and staff performing any particular function. A good audit service needed a parallel structure where messages could go up and down within the firm as to what they thought about things in parallel with the ones going up and down the business being audited.

9. The statutory structure for the provision of audit services was not terribly relevant as compared with the management structure. Audit reporting was typically done initially on management structure and the issues were repackaged as an afterthought to make sure that they fitted the necessary local statutory requirements. In some firms and jurisdictions, it appeared to be more appropriate to operate through branches than through subsidiaries. In some situations that would be a wholly owned subsidiary and the auditor would be formally reporting to the board of that company and to the shareholders who were typically the next level up in the statutory hierarchy. In other countries, auditors would report on a branch of a business that was located somewhere else. If dealing with a branch structure, then it was all the more important to have a single firm of auditors. If different firms of auditors were auditing different parts of the business there was a risk that neither auditor may adequately deal with certain things. AFME gave an example of a business that had got rid of the local auditors because something went wrong with the management and statutory accounts, even though the last audit report had identified problems but said that they were being remedied.

10. With regard to component audits, AFME agreed that a company could employ a slightly smaller audit firm in one territory and increase its use if it was happy with its work. It was therefore within the power of certain companies to develop greater choice in audit services. However, if things did not work terribly well in the company (rather than the auditor), it was less certain that seamless feedback would be received. This was particularly true for large companies including its members with subsidiaries and unified products operating in the same country where there were many links. The parent company typically wanted to know whether these links were working properly (with regard to people, reporting systems, products and technologies). For this reason a typical large AFME member would consider that it did not have much option but to hire one of the Big 4. In the short term, the obvious solution was more choice in auditing services and for the second tier firms to grow. However, this was not easy to achieve.

11. Some of the second tier firms such as Mazars and BDO had carved out a market niche just below the Big 4. However, from the point of view of a CFO or audit committee, they would be typically nervous about going outside the Big 4 because there was a comfort factor involved with ‘knowing what you were getting’ in terms of quality of audit, quality of informal feedback, and the quality of the package as a whole.

12. In terms of Big 4 relationships, AFME’s large members typically contracted one of the Big 4 to do its main audit and the non-audit work might be provided by another of the Big 4. It was less critical that one firm did the non-audit work (than in the case of audit services). It was extremely desirable for the auditor to undertake due diligence work because the auditor understood the company’s systems. It was, however, less critical for the auditor to undertake other wider services such as tax advice and IT-systems.

Potential remedies

13. It was implausible to expect an audit committee of one of its largest members to hire outside the Big 4, merely for the good of the market (which would benefit from the expansion of firms other than the Big 4), considering the risks involved. AFME also thought that the regulatory environment could sometimes contribute to the market concentration in the supply of audit services, for example, as a result of current independence and conflict of interest rules. These rules narrowed the field even further, especially at the higher, more specialist end.

14. AFME's members' perception that the Big 4 were the only realistic audit option was widespread among investors and even stock exchanges (which saw the Big 4 as a type of condition for a listing). AFME noted that the EU proposals were also looking at restrictive lending covenants.

15. There were different considerations involved for a domestic market and a global market. For example, company number 250 in the FTSE 350 that had 80 per cent of its business in the UK with two or three factories and quite a number of distribution networks, some agents overseas and a couple of small subsidiaries, would have no particular problem in looking at three or four audit firms outside the Big 4. The situation was very different for NGOs. For example, NHS Trusts had a wider choice for audit services because all their operations were in the UK and basically one product was supplied. The downsides were high, however, for a company such as Goldman Sachs in appointing a second-tier firm to provide audit services.

16. When asked about issues arising in banks' control systems following the financial crisis, AFME maintained its view that the Big 4 were better at auditing these banks. The Big 4 had the technical skills but were auditing very difficult areas. The banks did not wilfully allow their control systems to become deficient; many people working for the banks did not spot where the risks were and the same was true of the auditors. As chairman of an audit committee for one of these banks, the safe option would be to choose the firm of auditors with the largest number of people with the greatest amount of experience in the area. All incentives went against going to a smaller firm with less direct experience. AFME agreed that there were risks that a fresh pair of eyes could pick up (for example if the auditor was changed) but those risks were outweighed by the need for knowledge including corporate and industry knowledge. For example, if KPMG or PWC were auditing a large number of financial sector operations, they would have a large practice and a considerable number of partners involved in that area. This experience was very attractive to the chairman of an audit committee or CFO when tendering for audit services.

17. AFME considered that the Big 4 typically managed the rotation of their staff well, including partner rotation and they were all very conscious of their own reputational risks. AFME noted that Andersen's demise occurred because its reputation had been compromised. Reputational risk was a very strong constraint on any partner in an audit firm.

18. A further difference between audit services provided to a 'hypothetical widget manufacturer' in the UK and a large financial institution was that there were far more people involved in auditing a large, global bank and audit staff rotate. There was therefore less risk of a cosy, comfortable relationship developing over many years as compared with a local situation where, for example, the CFO had been playing golf with the auditors for the last 20 years. It was much easier for a new partner in PWC, who had only been auditing a firm for the last three years, to tell an audit committee that a practice was unacceptable, even if it had been accepted by a previous partner.

19. The existence of only four large audit firms was not ideal and perhaps some of the mergers that had been allowed over the last 15 to 20 years were questionable. It was, however, very difficult to see how the Big 4 could be split up and almost inconceivable that it could be done without the USA taking the lead, and possibly required the European competition authorities to work together with the USA. When asked how AFME could see the market evolving absent regulation, AFME said that it liked the FRC approach of 'comply or explain' mandatory tendering. Companies were perhaps too reluctant to change auditor. If a company had global operations and the Big 4 were considered the only safe option, typically the other three audit firms were

already doing the company's non-audit work and possibly one of the other two might not be expert in the relevant sector anyway and the choice was narrowed to one.

20. It was not clear that mandatory tendering would help much. The audit firms worried that it would cost them significant amounts of money for a change in market structure that would not eventuate. A more transparent tendering process would be more desirable than mandatory tendering. Audit committees could be required to justify their choice of auditor and undertake a process that would allow the non-Big 4 firms to demonstrate their expertise. The purpose of improving the audit selection process would, however, be defeated if audit committees were unwilling to put their audit out to tender within a reasonable period of time. If statutory regulation required an audit to be put to tender, care needed to be taken that it did not just become an expensive exercise which produced no change.

21. If companies did change auditors, it took a while for the new audit team to get up to speed on what was happening, including finding out how the systems worked and establishing relationships. The company was likely to obtain better value from the audit process if there was a reasonably good working relationship between the audit team coming in and the company being audited. The relationship took a while to develop (one to two years, possibly longer in some cases). For example, a new audit team might have found it difficult to pick up the recent problems reported in the press about Barclays. That did not mean that a company should not change auditors but that it would not want to do so very often. These considerations were behind the note it submitted to the European Commission to show that the proposed seven-year audit was not efficient because it probably took around two to three years for an auditor to get up to speed together with the possibility that in the last year or two the outgoing auditor might lose focus. The risk that a company would only get value for money in the middle three to four years of the period was very unsatisfactory from the company's and shareholders' point of view.

22. AFME agreed with the counter-argument that an auditor who knew he was going could push harder in the last year, but considered this would only be the case for tangible factors. For example, if the auditor had established a relationship with the CFO over three to four years, it was easier for him to let the CFO know outside a meeting that it had concerns over certain practices and to be in touch if the CFO wanted to talk about the matter further. An outgoing auditor could not do this for obvious reasons.

23. An issue worth exploring on the evolution of the market was relaxing ownership rules of audit firms and moving away from the partnership model. There would be an incentive for external investors to drive forward an ambitious business strategy and capitalize these firms in order to enhance their capabilities. A strong incentive for expansion of especially the middle and smaller end of the audit firm market could be a different ownership structure with investors seeking returns and a different management. AFME also noted the references to the appearance of a fifth audit firm coming from China given the growing presence of the Chinese and the relationship that their companies would have with certain firms headquartered there. AFME noted, however, that it did not envisage the Chinese audit firms competing with the Big 4 in the short term.

24. This also served to illustrate the point that firms tended to grow together with the companies they audited. This, in part, explained why AFME saw a number of large companies retaining the same auditor for decades. AFME also noted that although changes in ownership could encourage new entrants to the audit market, it was much more likely to be at a national level, with the barrier remaining between the national and global market. Competition in the national market was much easier to foster for

example, it was easier to encourage greater firm rotation in the national market where the difference between the Big 4 and others was smaller in qualitative terms. At the global level, however, it was the quality differences as much as the size differences that restricted choice.

Summary of views

25. In summary, AFME did not like the lack of choice in the market for audit services. There were serious worries on many levels about what would happen if one of the Big 4 exited. Any recommendations for change, however, needed to produce a wider choice. Hypothetically, it would be welcome if the competition authorities could reverse some of the mergers that took place over the last 15 years and in particular the Price Waterhouse and Coopers & Lybrand merger. In this case, the USA and EU competition authorities had looked at the merger from a local level and it was not perceived as a sufficient problem in that area to stop. More choice would enable AFME's members to tender every 12 years or so with a realistic prospect that either a better alternative would be found, i.e. an auditor which would provide a better and/or cheaper service. Even if a better alternative were not found, it would encourage existing auditors to 'keep their pencils sharp' and to provide as cost-effective a service as possible. AFME was not sure that the Big 4 always did that for their clients. AFME did not think that the Big 4 consciously set out to pad the service but in a situation where there was only one possible auditor (or the audit committee perceived this to be the case) incentives might not be strong to provide the best value for money. AFME cautioned, however, that going out to tender was not terribly valuable unless the competitive bidders were genuine options.

26. AFME agreed that AFME members would support measures that empowered audit committees and moved the audit decision away from a purely management decision and more towards a shareholder decision. AFME qualified this by saying that the important consideration was the value of the audit package for both management and shareholders. It must be in the interests of the shareholders that the control systems work properly and if the management was able to sign off on the going concern statement in full belief that everything was okay, then they needed audit comfort on that. There was no conflict between management and shareholders on this.

27. In closing, AFME emphasized the global nature of the audit market and that key audit decisions were typically taken outside the UK. AFME asked for this global dimension to be taken into account when the CC came to make its decisions.