STATUTORY AUDIT SERVICES MARKET INQUIRY

Summary of hearing with the Financial Reporting Council held on 26 October 2012

Background

1. The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high-quality corporate governance and reporting to foster investment. It promotes standards of corporate governance through the UK Corporate Governance Code. It sets standards for corporate reporting and actuarial practice and monitors and enforces accounting and auditing standards. It also operates independent disciplinary arrangements for public interest cases involving accountants and actuaries.

FRC introduction

2. The FRC supported the Competition Commission's inquiry. It had been looking at this area for a number of years without finding clear ways to move forward.

3. As a regulator, its responsibility was to promote high-quality audits across companies but in particular with respect to public listed companies. The interrelation between competition and quality was important to it and it paid particular attention to actions to drive competition which might have a detrimental effect on quality.

Recently published guidance and rotation rules

4. The FRC recently introduced a requirement in its Guidance on Audit Committees that FTSE 350 Audit Committees should put their external audit services contract out to tender (or explain why not) at least once every ten years. The FRC considered that long audit tenures without retendering damaged investor confidence in audit quality and the company itself could not be certain that it was getting the best quality available in the market. The FRC was also concerned about the public perception of cosiness associated with long audit tenures which undermined the confidence in audit quality. The FRC wanted investors to have justified confidence in an audit.

5. The FRC considered that requiring firms to tender was a better option than some of the proposals put forward by the European Commission, such as the requirement for mandatory rotation. It believed that mandatory rotation reduced choice, since the incumbent would be excluded from acting. For some companies, this could significantly reduce choice of auditors due to independence issues and/or in certain sectors where there were less than four firms active in the sector. Retendering would maintain a greater degree of choice.

6. The FRC was concerned that high market concentration was not just having a detrimental impact on pricing (which it considered to be a secondary issue) but was also having an impact with lack of innovation, ideas and challenging approaches to audit. There was anecdotal evidence that Audit Committees were becoming better aware from tender processes of different approaches to audit of which they would have otherwise remained unaware.

7. The FRC looked at ways of seeking enhanced dialogue with investors but changed this to be a responsibility of the Audit Committee, as feedback from investors

suggested that they had limited time and resources effectively to discharge responsibilities under the stewardship code.

8. The FRC considered that the level of resources devoted to corporate governance within companies declined further down the FTSE index. Tenders provided an opportunity for audit firms to be challenged and to showcase their thinking—this stimulated quality and choice. Companies higher up the index were also likely to benefit from more frequent audit inspection. In the FRC's view, Audit Committee members gained some visibility of competing firms through their own other engagements as executives and non-executives of other companies. The FRC also published annual reports noting auditor performance which it distributed to approximately 800 to 900 Audit Committee members, including the Audit Committee Chairs of the FTSE 350. This report provided an overview of the audit quality inspections undertaken by the Audit Inspection Unit, describing the more important findings from its inspections, and including the key messages that it believed should be helpful to all audit firms and Audit Committees.

9. The requirement of 'partner rotation' was to refresh the independence of the audit partner, not the audit firm. The FRC noted that the effectiveness of the rotation was very much dependent on the individual auditor. There was a possibility that if partners had risen through the ranks of the audit engagement team in question, then there may be a less innovative change to the audit. The best partners were aware of the need to exercise independence. There might be some partners who were more concerned with client retention.

10. From regulatory perspective, requiring a change in partner to refresh independence was not there necessarily to change the audit offering of the firm. Part of the audit firm's job at the time of partner rotation was to smooth the transition. The regulations sought to prevent a new partner having too much prior involvement. The handover transition still left room for independence by a new partner. The degree of independence exerted depended on the quality of the AEP. Some did bring new thought processes and innovation.

11. The FRC noted that even in largest four firms there were only a handful of partners who would be allowed to sign large FTSE accounts.

Development of financial reporting/innovation

12. The FRC considered that the auditor could meet the demands of investors. However, there was no direct dialogue between the auditor and the investor and so any developments had to be sold to the company. Investors generally did not have the resources to engage. It was hard to get engagement with the right people and often difficult to get agreed views as to what investors might like in the way of enhanced reporting. This difficulty extended to obtaining a single view from an individual investor (different fund managers may have different views). In the FRC's experience, it was not easy to obtain a consensus view from investors on any given issue.

13. Within the investor, compliance teams tended to focus on governance issues (board appointment and remuneration). In terms of development of the audit, the engagement of operational people would be valuable but they did not have the resource to do so.

14. Financial reporting was also constrained by law, standards and regulations. However, the FRC did have other options. The FRC's proposals for additional disclosure in the Audit Committee report had been promulgated through the Corporate Governance Code. The FRC believed that better reporting drove better company

stewardship, which enhanced the obligation on the Audit Committee to provide a better-quality report. There was a perception that what happened in the audit was not sufficiently clear. Better reporting in the Audit Committee report could clarify what the key issues covered were.

15. Publication of this report was a matter for company boards. There appeared to be a strong appetite from Chairmen for publication of the report but a more neutral desire from Audit Committee Chairs. The FRC considered that some companies may start a trend, noting that companies such as BP and Man had already published some very good Audit Committee reports. It would be very concerned to ensure that such reports did not begin to be published in boiler plate fashion but believed that it was for companies to drive this.

Audit quality review team reports and audit quality

16. The FRC's comments in recent annual audit quality review team (AQRT) reports concerning audit firms reducing sample sizes/increasing materiality in response to fee pressure were based on observations from some, but not all, audit files reviewed. The FRC said that ACCs were able to discuss the materiality levels and approach to substantive testing with their auditors. There was a question at the moment as to whether materiality levels should be made public: this might go some way to bridging the expectation gap.

17. The FRC noted that there were limitations to what the AQRT reports could say/test with respect to quality, since: the review was through the eyes of the file and was not a re-audit; the reviewer was not present when audit issues were debated with the company or its directors/Audit Committee; and the reviewer would not know what additional information was requested or discussed if it was not documented.

18. There were plans that, in the future, reviews would include dialogue with Audit Committees to understand the discussion that took place between the Audit Committee and auditor.

19. The AQRT did not take the same approach as other regulators, for example in the USA, where if information was not captured in the file then the regulator would proceed on the basis that the issue was not covered by the audit. The AQRT's approach would be to seek an explanation and challenge that before accepting that a point was, in fact, addressed.

20. An unsatisfactory/3 rated audit was taken seriously by the AQRT. It would write to the auditors and to the company involved. Whilst the auditors might try to present the finding to the company in the best possible light, from the FRC's point of view these audits were in the bottom 10 per cent, and would involve an issue concerning a key judgement. A link could not be made between a 3 rating and the accuracy or reliability of the accounts.

21. The FRC noted that Audit Committees did not open the audit files and could not be expected to look through the entire audit file. The Audit Committee must assess the extent to which it thought the auditor had understood the key risks and issues in the audit, through the auditor's presentation to the Audit Committee, including the level of materiality applied. The Audit Committee must then decide if it was comfortable with the level of precision in the accounts and the sufficiency of work undertaken. It could also assess whether management had been challenged appropriately.

22. The FRC explained that sampling methods could be difficult for some Audit Committees to assess. Audit firms used statistical calculators to assess the level of

testing required, and it was not clear that all Audit Committees understood the intricacies of these.

23. The FRC considered that there was an 'IBM effect' in relation to the Big 4 firms and that Audit committees were risk averse. However, it noted that there was a difference between how large FTSE companies and AIM companies were managed (more owner management/involvement in AIM) and therefore there was a difference in what investors looked for from the auditors. The FRC said that BDO LLP/Grant Thornton UK LLP had made a strong play in AIM market about being responsive/dynamic to the needs of management/owner businesses and the way the audit relationship was run would be different from, say, a Big 4 firm auditing a FTSE 100 company.

Powers of the FRC

24. The FRC only had power to secure information from audit firms. It could not compel information from companies and so relied on companies to cooperate if it wanted to undertake any cross-checking of information it had from the auditor. The Government was aware of this anomaly but any changes to widen its powers would require primary legislation. That FRC noted that since July 2012, it was now more able to sanction audit firms at a more granular level.