STATUTORY AUDIT SERVICES MARKET INQUIRY

Summary of a hearing with institutional investors held on 16 April 2012

Background

1. The hearing was with representatives from members of one or more of the main trade bodies that represent institutional investment in the UK—the Association of British Insurers (ABI), the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF). The ABI represents the UK's insurance, investment and long-term savings industry, and has over 300 members. The IMA represents the asset management industry operating in the UK. Its members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes with some £4 trillion of assets under management globally. The National Association of Pension Funds represents 1,200 pension schemes in the UK with some 15 million members and assets of around £800 billion.

The use and contents of audit reports

2. The representatives said that the audit report itself had only a minimum perceived value as it was binary (in that the auditor could either qualify the opinion or not) and few reports contained emphasis of matter paragraphs. When financial reports were published, investors reviewed the audit report, but on a failsafe basis (ie to confirm that the report was not qualified). In the representatives' view, the value perceived in audit was in the audit process itself, in that this led to more accurate reporting. However, the process itself was very opaque. The representatives thought they had no meaningful influence on the initiation of the audit process, its operation, or output.

3. The best insight the representatives received with respect to the audit process was from reviewing the Audit Inspection Unit reports, PCAOB reports, and what they termed as anecdotal evidence from members of the profession, generally talking about specific cases. They saw the actual audit report as quite boiler plate.

4. The representatives noted that directors were under a duty to keep the market informed at all times of price-sensitive information .The audit report provided a basic level of assurance over historical information, was produced long after the preliminary announcement of results and, in the representatives' view, was too little too late.

5. The audit report was not used for investment decisions in itself but was considered to be a very important document to the markets, in that it gave markets confidence in the financial information disclosed by companies. If a company received a clean audit report, this provided reasonable assurance (by the auditor) that it would continue as a going concern for at least the next 12 months. This provided a basic level of assurance, but beyond that the representatives thought that the report was uninformative.

6. The representatives noted that there was significant debate under way within the FRC in the UK and the European Commission as to whether the audit report could be more informative. The representatives considered that the more important thing to develop at this stage was the Audit Committee report rather than the audit report itself. This was on the basis that in the first instance information should be provided by company directors rather than the auditor. The auditor's view of the audit committee report could also be important.

7. That said, more could be put into the auditor's report. In particular, the report could identify issues that had been scrutinized in detail by the company during the audit process. The representatives referred to the audit committee reports, and Global Disclosure Guidelines[1] which set out guidelines on what could be included in an audit committee report, which investors would find useful and interesting.

8. The representatives noted that whilst the audit report on the accounts was addressed to the shareholders, when companies announced their results, in their view, there was no audit report as such albeit that the auditors were required to agree the statement and indicate any likely modification that may be included in their report on the accounts. The representatives considered that this had devalued the audit report.

9. The representatives noted that analysts spent considerable time analysing the numbers in the reports and accounts. In their view, most analysts did not place any value on the audit opinion itself, preferring to rely on their own analysis of the accounts. Analysts also tended to look for a more granular source of data, for example with regard to banks, by reviewing their regulatory returns that provided additional information as to contingent liabilities. Investors, in this context, tended to be forward looking but necessarily based their views on some historic information that had been audited.

10. The representatives considered it disappointing that there had not been more competition and differentiation in the supply of audit services. In their view, they all trended to the lowest common denominator. Auditors did not give any more informative and useful reporting than they were compelled to by regulation. Auditors rarely provided an emphasis of matter paragraph in the audit report because it was perceived as giving a negative signal. In the representatives' view, the audit opinion was very much boiler plate, the substance of which had not changed much over decades: there had been very little innovation. Shareholders were the customers but had never been approached by auditors or audit committee chairs regarding the extent and content of audit reports.

Investors' engagement in audit

11. The representatives noted that investors had recently relied on the Audit Firm Governance Code (which contained the principle that auditors should have a dialogue with shareholders) to initiate dialogue with auditors. Scottish investors had spoken to four of the largest seven auditors in the UK. They had typically spoken with a senior partner and one or two independent non-executives of the LLP firms. This allowed them to have a more informed opinion as to whether to vote in favour of auditors at AGMs.

12. More generally, the representatives considered that auditors were unwilling to speak to shareholders since auditors had access to privileged information. This left the general meeting as the only forum where it would be possible to speak to the auditor. This rarely happened because the chairman of the meeting controlled access to the auditor. On those occasions where investors had sought to put issues to the auditor, they had been blocked by the chairman.

13. The representatives referred to an example of an investor providing the Big 4 firms with a risk review of the FTSE 350, listing the ten highest-risk companies that the firms audited with particular bias towards accounting risk and any particular outliers

[1] www.enhanceddisclosure.org/pdf/guidelines.pdf.

that were thought questionable. The auditors were not prepared to discuss particular cases so this exercise amounted to the investor giving its perspective.

14. In terms of additional disclosure, the representatives considered that it might be useful to understand what the five most contentious points discussed at the audit committee were. This would give investors an opportunity to discuss any issues with, for example, the audit committee if they wanted further information. Certain companies had volunteered more information regarding such key audit issues in recent annual reports (eg BAT, BP, Barclays).

15. The representatives noted that whilst the audit committee fell under the internal corporate governance framework, it oversaw the audit process and the governance around the audit. The purpose of the audit was to protect the company itself from errors, omission or wrongdoing, and to give shareholders the information they needed to exercise their rights in a general meeting. The role of the auditor and audit report should not be subsumed by the audit committee.

Auditor accountability

16. If there were flaws in the *Caparo* judgment, in the representatives' view, they were to limit the duty of care to the shareholders as a body rather than to individual shareholders. The duty of care was primarily the responsibility of the company, and in the case of failed companies, new management would typically be more interested in remedying the fundamental problems in a company rather than pursuing legacy issues such as, say, poor historic audits. The representatives noted, however, that there was the possibility of a derivative action by shareholders where the company directors refused to act on shareholders' behalf (Part 11 of the Companies Act 2006).

17. In comparison with audit, advisers had a much sharper line of accountability to shareholders when acting as reporting accountants when advising, for example, on a rights issue. The representatives' general view was that the output from a firm as a reporting accountant was higher quality because there was a higher degree of diligence that went into the relevant documents and because of the involvement of lawyers, sponsors etc. It noted that audit reports were generally included as part of the listing particulars, which meant that subscribing shareholders could litigate directly if there was negligence in the preparation of the audit report.

18. That shareholder–accountant line of accountability had been dulled in the case of audit by the *Caparo* judgment, which provided an inappropriate cloak for auditors. The representatives noted that some investors held the opposing view that it was appropriate that there should be different standards for first admission to the markets than for ongoing reporting.

Choice of auditors

19. The representatives said that company management rarely discussed the choice of auditor with investors. Investors usually heard about a change in auditor only after it had taken place. Audit committee chairs equally did not discuss the issue with shareholders. The representatives indicated that under the UK Governance Code, primary responsibility for engaging with investors fell to the Chairman of the board. However, routine meetings with shareholders were usually held by the Finance Director and the Chief Executive. Investors without significant shareholdings would have meetings with a company's 'investor relations' function. In routine governance matters, the first port of call would be with the company secretary and if the scale of concern was

large enough then an investor would meet with the Chairman or a senior independent director. Change of auditor rarely featured on the agendas of any of such meetings.

20. It was the responsibility of the audit committee, on behalf of the board, to own the audit process, and while many audit committees probably did it well, the integrity of the process depended on audit committees having sufficient independence from management. Management naturally had a vested interest in minimizing the challenge posed by auditors.

21. The representatives noted that currently investors had very little information with respect to audit quality. This meant that they were unable to debate such issues usefully with a company. The representatives said that they did engage on issues such as the level of non-audit fees and other proxy indicators of the level of independence of the auditor, where it could obtain relevant (if indirect) information.

22. The representatives referred to some recent examples of engagement on audit issues. For TUI Travel, the switch of audit firms was forced by the controlling shareholder. In this case, the representatives thought that investor engagement had been fairly futile and time-consuming. There was also the case of Rentokil, where investors were exercised over the internal and external auditors being the same firm to save money.

23. The representatives thought that a change of auditor or audit committee chair should be a trigger for investors to ask questions and understand the reasons behind the change. However, since often they were not aware of the change until the AGM, this was difficult. Further, because of confidentiality arrangements, it was very difficult for investors to obtain any real information from the auditor about the reasons for the auditor's departure. Investors also had very little visibility regarding prospective tenders for auditors.

24. On rare occasions, investors had voted at AGMs against the reappointment of an auditor. This had tended to be for reasons of independence and the level of non-audit fees that an auditor may be earning from a client, rather than because of any inherent judgement of the auditor's quality. There have, however, been occasions when investors have taken voting action if investors had concerns about overly aggressive accounting treatments adopted by management. The representatives gave an example where a Finance Director may ask an auditor what the range was, consistent with the accounting standards, for a fair valuation for something. The auditor may propose a range between, say, 70 and 140 with a fair valuation of 95. The Finance Director would use the 140 figure. Since the auditor had indicated this to be within the accounting standards, it would find this decision hard to contest.

25. The representatives thought that the quality of reporting would be improved if such subjective issues were identified and investors notified. At the moment, the representatives considered that the disclosures were not useful. They noted that there were cases of significant variation in the numbers reported by financial institutions that held the same type of instruments, for the same purpose, even where those institutions had the same auditor.

26. The representatives thought that the reason for such anomalies was because the audit had become too much of a utility product. It was no longer differentiated on the basis of quality as very little judgement was required when undertaking an audit. Auditors had lost the ability to resist unrealistic and racy judgements taken by directors. Instead competition was now partly on the basis of reputation for sector expertise and partly on the provision of other services.

27. The representatives also considered that there was an additional issue regarding the degree of concentration and lack of switching in the market. Audits in particular sectors (such as finance) were provided by very few firms.

28. The representatives considered that despite the concentration and lack of choice, auditors seemed to oblige the companies they audited and sometimes accepted unrealistic judgements, although it was a matter of degree, in that there would be a point beyond which auditors would not be so obliging. Further, the representatives noted that auditors often offered more than just the audit product and there was more competition and choice over the provision of non-audit services than audit.

29. Referring to the going concern statement, representatives noted that a study by the ACCA had found that when the going concern statement was first introduced, it meant that companies would seek to resolve problems earlier. Thus companies initiated restructuring and recapitalization programmes and there was a reduced failure rate.

Non-audit services

30. The ratio of audit services to non-audit service was approximately 50 per cent in the UK. In France it was around 5 per cent. In the USA, it used to be over 100 per cent but since Sarbanes Oxley it had dropped to around 25 per cent. The representatives thought that the margin audit firms earned was much higher on non-audit services than audit. In terms of the usefulness of the audit in the USA, the representatives said that the dynamic was slightly different. The USA had a different accounting framework, so that investors looked for different things in a set of US accounts. However, in terms of the actual quality of the audit, the representatives did not think the USA had any better transparency than in the UK.

Role of audit committee

31. With respect to engagement with audit committees, the representatives noted that the audit committee was part of a unitary board and did not necessarily act for shareholders. The audit committee, however, had a distinct function and the independent non-executive directors had access to the accounts and the auditor.

32. The representatives said that investors had very little visibility of the terms of engagement of the auditors with the audit committee. Better visibility would give them a better idea of what the concerns were, what auditors were doing and so to take a view on the quality of output of the auditor and of the audit committee. While audit committees might be presumed to be working well (and their workload and number of meetings had increased substantially), there was often insufficient transparency for investors to be able to determine this.

33. The representatives noted that over time, the terms of reference for audit committees had grown. Many were now audit and risk committees and the amount of time that could be devoted to increasingly complex reporting and auditing standards was likely to be less. The representatives were surprised at how infrequently audit committees sought independent advice regarding how their auditors were acting, in contrast with remuneration committees. Audit committees tended to go back to their auditor with questions about any particular accounting treatment.

34. In the representatives' view, the main function of audit committees was not to provide a link to shareholders. This would split the unitary board—the representatives supported the concept of the unitary board. However, there was some perception that

audit committees had insulated the auditor from investor scrutiny. This was in contrast to the USA where there was more pressure from investors for auditors to put more in their reports regarding their interaction with the audit committee.

Auditor quality

35. The representatives did not consider that there was a difference in audit quality between the Big 4 firms and the others. They could discern some strengths and weaknesses with regard to certain issues from reading Audit Inspection Unit (AIU) and Public Company Accounting Oversight Board reports. Within firms, there were differences between partners. Investors, however, would not have knowledge of the abilities of particular partners within firms. They were, however, starting to discern, via the dialogue under the Audit Firm Governance Code, the distinctive styles and approaches of different firms. This suggested that there was some differentiation among the Big 4 firms.

36. The representatives noted that when there were eight large firms, there was significant differentiation between them. This was around the cultural backgrounds of the firms, and in audit philosophy and style. There was also a clearer differentiation in the reports of the different firms. At that time it was easier to differentiate because there were no universal auditing standards (such as ISAs). The standard setter, the International Auditing and Assurance Standards Board, drew heavily on the Big 4 which might be seen as a form of regulatory capture. Historically, the 'true and fair' view was a more substantive concept in both accounting and auditing, with prudence clearly embedded, and different firms to some extent operating with their own rulebook or principles.

37. Many of these characteristics had been lost in the more formulaic approach that accounting and auditing standards now require. Historically, when there were eight firms, each had different cultures and geographic strengths, some being stronger in North America, others in Europe. Today, strength in China may be an area of possible differentiation. Another difference that had been picked up in recent dialogue was around client acceptance and client continuance policies.

38. The representatives noted one instance [✂] where investors expressed concerns about the reliance a particular auditing firm may have begun to have on a particular client because it was growing quite rapidly and quickly emerging from the small company universe. This may have influenced the company's decision to change to a Big 4 firm.

39. A few years ago, some investors wrote to a number of FTSE companies saying that if they did go out to tender, they did not necessarily expect them to appoint a Big 4 firm.[2] A more recent survey of 635 financial directors, chief financial officers and financial controllers—a representative cross-section of UK plc—in the autumn of 2009 by *Accountancy Age* and *Financial Director* on audit firms' service to their clients[3] had shown a range of views on the Big 4 and mid-tier firms. Some were unconcerned about a mid FTSE 250 company having a non-Big-4 firm but because there appeared to still be some prejudice against the mid tier, most companies and audit committees were deciding to use the 'safe' option and appoint a Big 4 firm. Investors considered that only companies that had a significant international reach,

[2] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/hermes_equity_ownership_management_hearing_summary_.pdf.
[3] www.accountancyage.com/aa/feature/1809503/audit-services.

nature and network, required a large audit firm. This they considered was unlikely to be a requirement below the FTSE 100.

Audit fee and quality

40. Investors were not particularly sensitive to the audit fee. They were not necessarily opposed to increases in the fee but were concerned about what they were getting for their money. If there was an improvement in perceived quality, there could be a willingness to pay more for it.

41. Increases in audit fees were possibly required to increase competition because at the moment firms outside the Big 4 did not have the resources to grow. However, fees had been increasing through the 1980s and 1990s but the representatives were not sure how this increase in revenue had been spent. They were not aware of any innovation in audit and the increased revenue may have been spent on reinforcing the firm brand. In the representatives' view, the limited partnership structure largely operated a cash-in cash-out structure and provided little incentive to innovate operating a short time horizon.

42. The representatives considered that a true and fair view and professional scepticism were the factors that defined audit quality, but could not judge these directly. The financial crisis had raised a number of concerns about whether audits had been delivering a true and fair view. The AIU had reported that it did not think that there had been sufficient professional scepticism. On the basis of the audit report the representatives could not judge whether the audit had been of a good quality or not: all reports were the same.

43. The representatives felt that the change from unlimited liability partnerships to limited liability partnerships changed the approach taken by firms. When operating under unlimited liability partnerships, partners took a more responsible approach. The LLP structure limited auditor liability, just as the *Caparo* judgment had done.

44. The representatives thought that it was very difficult to judge the quality of audit committee chairs.

Auditor independence

45. The representatives considered that auditor independence was very important as it underpinned the level of professional scepticism that was likely to be applied by the auditor. As well as looking at the level of non-audit fees as a signal of the level of independence, audit tenure was also very important. The representatives noted that the ABI, through its voting service, looked at the composition of audit committees which investors scrutinized to assess any pattern of lack of independence across the audit committee as a whole.

46. Whilst there needed to be more rotation, a number of the representatives did not support mandatory rotation and would be particularly concerned with a mandatory firm rotation period that was shorter than five years. What investors would not want to see was a change of auditor to coincide with a change of other senior management within a company. The representatives considered that the five-year rotation of the audit partner was an appropriate period, but in and of itself was not enough to ensure independence.

47. The representatives felt that below a certain firm size the requirement to be demonstrably independent might act as a barrier to entry if, for example, a smaller firm picked up a large client.

Other

48. The representatives considered that the reason why the audit firms competed so fiercely for talent in the recruitment market was because even if recruits did not stay with the firm, there was a good chance they would become a source of revenue for the firm in subsequent positions they took up. There was also an element of such alumni being alumni for the Big 4 rather than for a specific firm, ie they would favour the Big 4 over mid tier firms. Big 4 firms successfully placed secondees in Whitehall, within regulators, standard setters and within Brussels.

49. The representatives thought that the Big 4 were starting to change their approach in terms of recognizing that investors and shareholders were their customers.

50. The representatives thought that the Big 4 were engaging more positively with investors and there was more dialogue with them.

51. The representatives considered that the accountancy profession regulators needed to address internally whether they could be captured. The representatives noted that the CC had Roger Davis as an adviser to the panel. It would like to see some checks and balances to ensure that Roger Davis was not providing most of the internal advice to the Group. The CC noted that it was very transparent about Roger Davis's role and the sole decision-makers for the inquiry would be the five Group members.