STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of calls held with Company M

CC note

See: www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/case_study_cover_note.pdf.

Company M is a wealth management group, specializing in providing face-to-face advice to individuals, trustees and businesses. In consequence of successive mergers and acquisitions, the incumbent auditors have on two occasions been replaced by the acquirer's auditors [✂].

Views of the Chief Financial Officer

1. The Chief Financial Officer (CFO) explained that none of the changes in audit firms had been enforced [✂] but it had made sense to use the same audit firm as the parent company, not only on grounds of efficiency, since the firm already audited large parts of the parent Group, but also because the high purchasing power of the parent could serve to restrain the growth of auditor fees. However, Company M had insisted on a separate audit team and engagement partner from that auditing other parts of the parent company and group. The company was audited from one office, [✂] whilst the parent and the group was audited out of another [✂]; the CFO thought that the 'Chinese walls' arrangement had worked well.

2. [✂]

The 2008 change of auditors

3. There had been no formal tender in 2008. The change in auditors had been a desk-top process, with Company M meeting the audit partners to make sure they had the necessary skills and had no conflicts of interest (mainly in relation to any work on behalf of other financial institutions). The company insisted during the negotiations that there would be no increase in audit fees.

4. Inevitably the exercise had involved disruption for management (but it was helpful that one senior person in the new audit team had been on the company's audit team some years earlier). There was also always a risk in taking on a new firm: if there was a problem, a new auditor, coming in on the first day, was less likely to pick it up than an auditor with greater knowledge of the company. It took about three years for a new auditor to get fully up to speed. The CFO did not think that such a risk could be quantified, but believed it could in some cases be substantial and was 'not trivial'. Moreover, the CFO said, without putting any estimate of the man-hours involved, that it was painful to induct a new audit firm. The CFO noted, however, that there was a prolonged handover period that allowed the successor auditor to obtain information from the predecessor. [✂]

5. The switch in auditor had been driven by [✂], and as a result the company did not have the ability to fully determine the timetable of the switch which could have reduced the disruption to some extent.

6. Company M continued to ensure that the right people from the audit firm were working for it. This was largely to ensure that no conflicts of interest arose (and the company applied similar scrutiny to all its outsourced providers). The audit partner was shortly to be rotated and the company would be thoroughly assessing the successor before agreeing to the appointment.

7. The CFO had not had any interaction with investors on the issue of choice, or tenure of auditor.

Relative strength of the Big 4

8. The CFO did not consider that there was much difference between the capabilities of the Big 4 audit firms, in terms of their people and their abilities. Their styles differed and the interaction with staff was often an important factor in the choice of auditor. Company M gravitated towards the Big 4 firms because of the complexity of the issues and information involved in the company's affairs. The CFO questioned whether regulators would accept the appointment of a second- or third-tier firm to audit a complex financial company. Moreover, the company's shareholders would be likely to question such an appointment.

9. In the CFO's view, companies should avoid using the main auditors for other consultancy services unless it made sense to do so. The company had for this reason changed its tax advisers as a result of the change of auditors in 2008. This had been inconvenient and frustrating but had been dictated by company policy.

10. The company had noted that the new auditor undertook more transactional testing than had its predecessor but thought that this could reflect the present state of the financial market and the need for greater controls, rather than any differences in the two firms' corporate approaches. The change in scope had been reflected in the level of fees charged.

Other possible remedies

11. The CFO's views on some other possible remedies can be summarized as follows:

    (a) Mandatory tendering: would add to bureaucracy.

    (b) Mandatory rotation of audit firm: acceptable if a reasonable period of time was allowed (say ten years; five years would be too short an interval).

    (c) Prohibition of 'Big 4 only' clauses in loan documentation: a sensible proposal.

    (d) Strengthened accountability of the external auditor to the Audit Committee (AC): realistically day-to-day contact would be with the CFO and this channel should be retained.

    (e) Enhanced shareholder-auditor engagement: ignored the reality that some 20 people turned out for Company M's AGMs—generally small shareholders and retired people—and there was little or no discussion of resolutions before they were voted through.

    (f) Extended reporting requirements: generally, audit reports were getting too long and detailed, but there was scope for putting more into reports of the Audit Committee Chair (ACC).

12. The CFO suggested that the tendency of companies to recruit accountants from among those who had been working on the external audit team might be creating a potential weakness in the market. The practice resulted in strong personal relationships persisting between some in the management team and the audit firm, and the Competition Commission might consider whether this characteristic of the market should be investigated.

13. The CFO thought that limits on the level of non-audit services should be introduced.

Views of the ACC ([✂])

14. Company M's ACC had not been in that position when the audit engagement was last tendered, but had experience of both tendering for, and switching, auditors when he was Chief Executive of one company ([✂]) and non-executive director of another ([✂]).

Previous experiences

15. As Chief Executive [✂] the ACC had attended AC meetings. He recalled that there had been some concern about some aspects of the performance of the company's long-standing auditor (KPMG) and the company considered the time was right to put the engagement out to tender. The concern related not to the technical quality of the audit, but a degree of complacency had crept in and the firm was no longer proactively offering a value-added service. The cost of the audit was not an issue and it was unlikely that the tender had led to any savings.

16. The company invited the Big 4 to submit proposals. One declined [✂] but the other three firms contested the tender vigorously. The tender process was led by the non-executive ACC. It had been extremely time-consuming, especially for the finance staff, with three firms having to be taken through the process of understanding the company and its systems. About 10 to 15 staff were closely involved.

17. [✂] The post-appointment, induction stage was even more time-consuming.

18. [✂]

19. Until recently, Company M's ACC had been on the board of a bank ([✂]). The Group AC instigated a proposal to tender for an external auditor on the grounds of good governance. The incumbent ([✂]) had been engaged for some time. There was no serious dissatisfaction with the firm's performance but it was considered desirable to test the market. The conduct of the tender had been a joint effort by the AC of the parent and the AC of [✂]. Three of the Big 4 firms were invited to tender; the non-executive board members had one-on-one meetings (lasting a couple of hours) with each firm; written submissions were followed by oral presentation; and internal discussions culminated in the choice of [✂]. Overall, this was a reasonably time-consuming exercise but not a big overhead. The more intense period followed as the bank got to know the firm and the Audit Engagement Partner (AEP).

20. The benefits of switching were to obtain a fresh perspective on the accounts and the control environment from a firm that would have experience of other companies.

Switching at Company M

21. By the time the ACC joined Company M, it was [✂] second year-end and the difficulties inherent in switching had all been ironed out. It appeared, from what

others were saying, that the new firm's performance in the second year was a great improvement over the first year's performance. By that stage, the firm had become familiar with the risks of the business and the control systems and had become attuned to the company culture. This was helpful to the incoming ACC.

22. The ACC considered that a year was about right for a firm to become familiar with a company of the size of Company M, given that it would have invested considerable resources to do so. The challenge and the time needed could be expected to be considerably greater for a much larger company.

23. The ACC saw the benefits of switching in terms of 'value added'—bringing to the company a fresh, independent perspective, derived from the firm's external experience and knowledge. A new auditor brought a fresh assessment, derived from asking basic questions, particularly related to the company's control systems.

24. Tendering also brought the benefit of testing the market, obliging firms to study the company in depth before making an offer of a 'proper' price and allowing the company to make meaningful comparisons.

25. Risks might arise because some continuity was inevitably lost, and some issues might drop between cracks or not be properly considered. These risks had not materialized in his experience.

Fees

26. Fees were not a primary concern for the ACC as they were relatively modest ([✂]) relation to company profits. The ACC would look at what peers were paying for an audit, based on figures disclosed in public accounts. This information might be used as leverage during tender negotiations, and could sometimes lead to reductions in fees, but the effectiveness of these types of comparisons was limited: it was not an alternative to proper market testing. Differences in fees would have to be substantial to justify a change of auditor on that account alone. The primary concern was with the value of the services being offered.

Next steps

27. The ACC said it was too early for the company to be considering putting the audit engagement out to tender. The next stage to judge the quality of the new audit partner would be when the AEP was next rotated [✂]. The key relationship was not with the firm but with individuals within that firm.

28. The ACC had meanwhile kept close to other auditors. He recently, for example, held a tender for the conduct of the internal audit, leading him to become acquainted with other auditors. He intended to keep these contacts in play as an informal network.

Other remedies

29. The ACC's view on other remedies listed in the Notice of possible remedies can be summarized as follows:

    (a) *Mandatory tendering or rotation*. The ACC would not oppose mandatory tendering or mandatory rotation; the key issue would be their frequency.

    (b) *Prohibition of 'Big 4 only' clauses in loan documentation*. The ACC had seen a couple of instances where the depth of analysis of firms outside the Big 4 firms

was insufficient to spot important issues. The ACC did not therefore support complete prohibition but could see a case for obliging companies to justify why they limited work to the Big 4.

(c) *Strengthened accountability of the external auditor to the AC*. It would, for example, be possible to remove the Finance Director (FD) from the negotiation of the auditor's fees, but it was questionable that this would bring any gain. It would be a brave ACC who changed the audit firm against the wishes of the FD.

Nonetheless, the ACC considered this to be an important area; it was important for the ACC to be able to have a direct dialogue with the AEP without management being present. There should be no fear on either the ACC's or the AEP's side that discussions had to be 'edited' in case they got back to the executive management.

(d) *Enhanced shareholder-auditor engagement*. It was important for the ACC to be available to shareholders. However, the idea of holding an investors' day before the AGM was unlikely to arouse much interest in the external audit; shareholders had never spoken to the ACC on the audit or the length of time between switching. There would be more interest in other corporate governance issues and in risk (outside the AC's ambit). It was not clear now investor days would promote competition.

(e) *Extended reporting requirements*. It was uncertain how changes in the level of disclosure had changed the level of the engagement of external stakeholders.