STATUTORY AUDIT SERVICES MARKET INVESTIGATION

[Company G]

Background

1. [Company G] (the company) was a worldwide banking group. Its business incorporated personal, corporate and investment banking, as well as wealth management and credit card services.

2. The company was ranked in the top 20 of the FTSE 100 index, with a market capitalization of around £[✂] billion, and it was also an Securities Exchange Commission (SEC) registrant. In 2011, it reported net operating income of £[✂] billion and profit after tax of £[✂] billion.

3. The company's major investors were institutional shareholders. [✂]

4. PwC (and its predecessor firms) had been the auditor for over 20 years [✂].[1] The audit fee in 2011 was £[✂]. PwC audited the company's subsidiaries around the world. In [✂] it ran a joint audit with [✂].

The Group Financial Controller's view

5. The Group Financial Controller (GFC), [✂], reported to the CFO [✂]. He had been GFC since 2010 when he joined the company from [a Big 4 accountancy practice (which was not PwC)] where he was an audit partner.

6. The GFC trained as a Chartered Accountant at [✂], qualifying in 1987. He remained with the firm for ten years working in Audit, Consulting and Corporate Finance in [✂]. He worked at a division of the company [✂] between 1997 and 2002 as Global Head of Audit and also in the risk function. From 2002 to 2006 he worked at [✂] and then he joined [the other Big 4 firm] as an audit partner in 2006 before rejoining the company.

7. The GFC had therefore worked either as an auditor or with auditors from [three of the Big 4 firms] [✂]. He had experience of working with all the Big 4 firms in non-audit capacities. He had also worked with smaller firms such as [✂] and [✂], although to a much lesser extent.

Relationships

Auditors

8. The GFC described his interaction with the auditors as extensive throughout the year. The interaction was most intense around the half-year and year-end reporting when he spoke with the auditors daily and sometimes several times a day. Throughout the rest of the year he spoke with them approximately once a week. He was aware of which parts of the company the auditors were auditing at any time, who was on the team, the sorts of meetings the auditors were attending and with whom the auditors were interacting at the company.

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[1] [✂]

Audit Committee

9. The GFC attended most Audit Committee meetings. He was responsible for preparing the accounts and other papers (including half-year and full-year announcements, the Annual Report, interim management statements, SEC statement, other issues etc) that were presented by the CFO for the Audit Committee to discuss and approve. There were between 10 and 12 Audit Committee meetings a year. Some were fairly short, perhaps half an hour, and others were longer, up to 3 hours. There would be private sessions (ie sessions without management) for the auditors and Audit Committee either at the start or end of the meetings. There was also a direct relationship between the senior AEP and the ACC.

Shareholders

10. The GFC had a limited direct relationship with shareholders. The shareholders needed to approve directors' recommendation to reappoint the auditors.

11. With regard to Pensions Investment Research Consultants' press releases urging shareholders to vote against auditor reappointment, the GFC said that this on its own would not influence management. Management were concerned with the independence, skills and experience and efficiency (value for money) of the auditors. However, if shareholders did not vote in favour of reappointment for any reason, then the company would need to tender the audit. He was not aware of any concerns from shareholders over the selection of PwC or any other challenges to its reappointment.

12. Publication of the 2011 audited accounts did not have significant impact on the company's share price. The share price would only tend to move if the published results were materially different from the analysts' consensus and the company would not want to be in a position of publishing figures that were vastly different from the consensus.

The audit plan

13. The audit plan was developed by the auditors on a bottom-up basis: it was their responsibility. The auditors spoke to different people across the company to assess the key risk areas and then they considered the relative importance of these risks. The auditors would build up a plan of where they would spend their time auditing. The plans for each part of the business were collated and presented to the GFC and CFO for their comment. The input from the CFO and GFC was a top-down check on the areas of risk identified by the auditors, to verify that what the auditors had understood made sense to senior management.

14. PwC subsequently presented the audit plan to the Audit Committee explaining how and where they would spend their time, what the relative areas of risk were etc. This was a two-way process where PwC had the opportunity to set out its understanding of business and audit risks. The Audit Committee could then highlight if there were additional areas they considered needed to be covered or where they felt there should be a change to the audit plan. The auditor sought input to the audit plan from the non-executive directors and management. The GFC explained that the audit plan was formally discussed once a year, but that issues were discussed as they arose and the plan updated and/or varied accordingly as risks increased or decreased over the course of the year.

15. The GFC said that with regard to the joint audit of the [✄] subsidiary, the challenge was making sure that there were no gaps or overlaps in the two audit firms' work. He saw joint audit as an added complication rather than an added assurance.

Resolution of audit issues

16. Audit issues were discussed between management and auditors at the business unit level as and when they arose. If there was a significant matter or a disagreement then this was flagged up both via the local audit team to the central audit team and via the local CFOs to the GFC. These issues would then be addressed via a structured process for the resolution of audit issues. This process had four stages:

   (a) Legal and Technical Committee. The GFC chaired this meeting (attended by around 30 people and PwC) to discuss any audit issues arising and any financial documents that the company published. Material issues from this meeting were flagged up to the Disclosure Committee (either disagreements remaining or areas where judgements from a senior body was necessary).

   (b) Disclosure Committee. The CFO chaired this meeting (attended by around ten people, including the Head of Risk, Group General Counsel, Head of Investor Relations, Head of External Communications, Group Treasurer, and PwC). The GFC presented the significant matters that had arisen from the Legal and Technical Committee.

   (c) Audit Committee. Any material issues that had arisen from the Disclosure Committee meeting were raised with the Audit Committee Minutes of Disclosure Committee meetings were provided to the Audit Committee (chaired by the ACC; attended by the non-executive director members of the committee, senior management (ie CEO and CFO) and PwC). Anything important would be indicated to the board—although this was rare as the main members of the board attended the Audit Committee, except for the Chairman.

   (d) The board. The board was the final stage where issues could be raised with the full board if necessary.

Auditor selection

Annual reappointment

17. The GFC was involved in monitoring the quality of the audit. A thorough questionnaire was sent each year to around 40 or 50 people around the company who had the main contact with the auditors during the process.

18. The questionnaire asked staff to rate the auditors (collectively as PwC and individually as senior staff providing the audit) between zero and ten on the following behaviours and attributes:

   (a) robustness of audit:

      (i) independence;

      (ii) knowledge of business and risks; and

      (iii) effective liaison with internal auditor;

(b) quality of delivery:

(i) timely resolution of issues;

(ii) communication and presentation of outputs; and

(iii) working relationship with management;

(c) quality of people and service:

(i) 11 categories that covered understanding of industry, effectiveness of recommendations, communications, new ideas, judgement, technical expertise, experience, coordination etc;

(d) transition of lead audit engagement partners;

(e) value:

(i) overall quality and value;

(ii) areas of service which added most value;

(iii) areas for improvement; and

(iv) willingness with which PwC provided input on matters not clearly within their remit but on which they had knowledge; and

(f) overall.

19. This questionnaire was sent out in quarter 3 by the Company Secretariat and the results were collated and reported to the Audit Committee in January/February each year. The results of this survey formed the basis (and were the main input) for recommending the reappointment of the auditors. The results of the 2011 survey stated that overall service received last year was good.

20. The GFC said that in terms of the qualities that he required from an auditor, he considered independence, and quality and expertise, to be prerequisites. Following this, he looked for value for money and efficiency.

21. PwC had not been asked to repitch for the work during the GFC's tenure. He did not think that the ACC alone could force a tender but he could certainly request one based on the recommendations from management and the Audit Committee.

Switching costs and trigger points

22. The GFC said that there were no plans to tender the audit but this was kept under review. The company wanted to ensure that it received an independent review using the best skills and expertise at the best cost. Audit was an extremely important service. The trigger points for a tender would be a slip in independence, skills or value for money. These factors had to be considered relative to the competition: if the company thought that another audit firm could provide a better service at a lower cost and with a greater degree of independence, then this would trigger a switch.

23. The GFC noted that a tender process would be a significant undertaking and such a decision would not be taken lightly. It took a long time to run a tender process. The costs involved would include:

(a) Tender process. Each participating audit firm would wish to meet at least once with several hundred members of senior management and this would include meetings with the prospective Audit, Tax and IT partners, as well as other disciplines. Meetings would be two-way and extensive as the audit firms would be seeking information for their proposals and the company would be seeking to understand the capabilities of the firms. These meetings would need to take place over an extended period of time.

(b) Independence. If there were to be a change in auditor, this would involve significant work for the new firm to be 'independent' (in line with the requirements of the SEC) of the company. The audit firm employees would need to change banking relationships (this included senior staff who were not working on the company's account) and other non-audit work provided by the firm may need to be suspended. In many cases consulting contracts were global and multi-year, so this would be complex.

(c) Getting to know the business. It would take considerable time for the auditors to know the business. It would take one to two, possibly even three, audit cycles for them to really understand the company's business.

24. The most significant downside to switching auditor would be an increased risk of the auditors missing something that management either did not want to share or that they had not fully understood.

Awareness of other options

25. The GFC had not undertaken a formal assessment of other auditors. However, he was clear on their capabilities and knew who audited the other large banks. Any future tender would be likely to include the Big 4 audit firms, as they had the capabilities and global footprint to undertake the work. He considered there to be differences within the Big 4. This was largely due to the individuals working in the financial services teams and the experience that they had acquired in terms of the financial services audits that they did.

26. The company had a peer group of global banks. The skills required to audit other financial institutions such as [✂] would be similar. The GFC would also be interested in the other large and global FTSE 100 work that the audit firm undertook.

27. The GFC had no issues with using an audit firm that audited a competitor subject to appropriate Chinese walls being in place. Indeed, there was a benefit to this as the audit firm would develop skills and experience by having a critical mass in a sector. He said that subject to Chinese walls, having a line of sight into the issues the different banks faced in relation to accounting treatment and judgement issues was a benefit to the company. It was important that they were applied with a degree of consistency across the industry.

28. The GFC had limited interaction with mid-tier firms. He did not think that they had suitable experience and expertise to audit the company as they did not audit other global banks or global FTSE 100 companies. He did not think they had suitable presence and expertise (ie an appropriate combination of reputation, size, experience, international coverage) to audit the company as they did not audit other global banks or global FTSE 100 companies. His perception was that it would be tough for them to demonstrate that they had the capability to do the company's audit.

29. Each of the Big 4 provided non-audit services to the company, as did other consultancy firms. The GFC had not received unsolicited bids for the audit work.

Fees

30. The GFC was able to benchmark the fees the company paid against other banks' audit fees. To counter the concern that all bank audit fees were too high as switching costs were high, the GFC said that the audit fee was also compared with other global FTSE 100 companies such as BP and Aviva. Benchmarking was undertaken in-house. Fee negotiations were undertaken on a bottom-up basis. PwC costed the work at the same time as setting the audit plan. Other colleagues in the finance function negotiated the fee on a business-by-business basis which was then brought to the CFO for Wealth, CFO for the Retail Bank, CFO for the Investment Bank, CFO for Africa, Head of Tax etc.

31. The fees were then collated for the GFC and CFO to consider across the Group and to recommend to the Audit Committee. The fee proposal would be taken to the Audit Committee and considered in the context of the completed service questionnaire (see paragraph 17) and the scoping of risks. The Audit Committee had input: the fee was not a fait accompli at this stage.

32. The company did not make a direct link between the fee it was paying and what it considered the audit firm's staff should earn. It was able to negotiate by trading off inflationary increases (such as wage bill increases) against audit process efficiencies.

33. Given the high switching costs that banks faced, the GFC said he was conscious that it was in PwC's commercial interests to push the fee to the point just below that which might trigger the company to tender. However, he considered that the fee the company was paying was in the right ballpark; if it was plus or minus £1 million this was not a key concern, it was quality that mattered.

34. The GFC noted that the audit fee was very small in relation to the total expenditure of the company (£[✄] million of £[✄] billion (ie 0.1 per cent) and that it was the company's reputation and hence quality that mattered most.

Quality

35. The GFC considered a quality audit service to have two strands:

    (a) appropriate challenge and independence of thought; and

    (b) an efficient approach to the work (ie to ask bona fide questions, but only once).

36. It was important at the planning stage to ensure adequate and appropriate scope. The questions the auditors asked should be intrusive but efficient. Auditors were a check both for management, the Audit Committee and regulators.

37. Management's visibility as to the quality of the testing that the auditors were undertaking came via the company's staff working alongside the auditors. For example, at the Group level the consolidation processes were tested and the company's team would report back on what they thought of the questions asked and the delivery of the audits.

38. The AEP set the tone of the audit and it was his/her job to make the audit engagement attractive to the best staff at the audit firm. The GFC had no worries in this case as he considered the company's brand to be one that the best audit staff would want to be associated with.

39. The GFC said that the audit firm provided the technical foundations of the audit through: the firm's auditing ability (technical approach and assessment of, and approach to auditing, the risks); its accounting ability (understanding of how to apply the standards); its industry expertise (other clients, retail banks, particular trading desks audited in investment banks etc); and its geographical expertise (skills in different territories).

40. The GFC said that the value-add of the audit from his perspective was the insight that the auditors could provide into the rest of the industry, so that the company knew what best practice was in terms of preparation of statutory accounts, intercompany reconciliations etc.

Partner rotation

41. The lead AEP had changed shortly after the GFC started. He said that from his perspective the transition was smooth and PwC had invested considerable time in ensuring that the new AEP was properly supported by the team and understood the company. There was a good handover, with the old partner being available as a sounding board for the new partner. There were approximately ten key partners on the audit worldwide and the rotation of these partners was phased. This meant that there was continuity, since only part of the audit team was rotating in any given year.

42. The company was given the choice of two in selecting the new lead partner. The partner selected did feel like a 'new pair of eyes' as he had 30 years of experience with a different client set: his background was not in financial services but he brought other multinational listed company experience. There had been no obvious changes in the audit approach or treatment of accounting policies on change of AEP. The new AEP had taken time to understand and be comfortable with his firm's approach to auditing the company and to judgement issues.

Restatements and external reviews

43. There had been no issues of account restatement during the GFC's tenure. There had been an Audit Inspection Unit (AIU) review and the company had received correspondence from the Financial Reporting Review Panel and SEC. These reviews had not raised any questions as to the competence of the audit. The items raised were current hot topics in reporting and so had already been discussed between the company and PwC. The company had not found it necessary to make any changes.

Auditors and the banking crisis

44. The GFC's view was that the auditor's role was to sign off a going concern statement at a particular point in time. He said that auditors undertook extensive reviews of the environment at that time to ensure that the environment supported that going concern opinion. In cases where the environment changed rapidly (as in the financial crisis) and where this change had been difficult to foresee then it might not be reasonable to expect the auditors to have foreseen this at the time of signing their opinion.

45. PwC undertook important work on going concern for the company. Its work on evaluating the external environment and assessing the company's ability to respond to it was important. In the company's case, as it had been, and was, a going concern, it had not been necessary to question PwC's approach.

46. The GFC did not think that there were lessons for audit scope arising from the financial crisis, but he did think that it was right that there was greater focus on liquidity risk and creditworthiness. His personal view was that the accounting standards had been shown not to be sufficient by the crisis and that they needed to be revised. An informed debate was now occurring that would be likely to result in some revised accounting standards, particularly around IAS39 (soon to be IFRS9) on financial instruments. It took time to get international agreement across accounting standard setters.

Non-audit services

47. It was important that PwC maintained independence and so the company was careful about the nature of non-audit work provided by PwC. This was limited to work that was assurance in nature, and where the auditor would already be up to speed through its audit work (there might also be a pricing benefit to the non-audit work as the auditors were familiar with the business area). The company would not appoint PwC to work on advisory assignments in operating platform, strategy or IT.

48. Any PwC work that was over £100,000 in value would need to be approved by the Audit Committee.

The ACC's view

49. The ACC [✂] was appointed to the company's board in [✂] and he had held the position of ACC since [✂]. He was appointed Senior Independent Director (SID) during [✂]. In addition, the ACC was Chairman of [✂] plc and [✂] plc. He was a non-executive director of [✂] and was previously a director on an industry accounting body [✂].

50. He trained as a Chartered Accountant at KPMG [✂].

51. The ACC said that he spent around a day a week on matters related to his role as ACC at the company. He said that if asked to do a job he would do it to the best of his abilities and therefore for a complex bank this meant that a significant amount of his time was necessary. The ACC said that he felt the company's reputation, as well as his own, was at stake if he did not do a thorough job.

Relationships

Auditor

52. The ACC was in very regular contact with the external auditors (PwC). He would meet or talk with them monthly throughout the year to discuss any issues that they might have. The meetings were two-way; the ACC would flag general issues in the sector that he sought PwC's view on or areas he was concerned with following his own discussions around the global businesses (see paragraph 54). The ACC also met with the internal auditors and spoke with them regularly, ie several times a month. There was a mixture of one-to-one and joint meetings.

53. The ACC met with PwC before Audit Committee meetings (there were up to 12 Audit Committee meetings per year) to discuss the papers that were to be presented. His view was that both too much, and too little, information was effectively no information.

54. He also travelled to the company's overseas subsidiaries and met local audit teams and local management (perhaps arranging a trip around a local Audit Committee

meeting). For example, in the last year, the ACC had visited various countries: [✂]. He used these to get a sense of the quality of the audit, in particular the culture of reporting issues in different locations. The ACC considered his job to be very difficult to do without meeting the relevant people around the business.

55. The ACC considered that his background (at KPMG) meant he was well placed to understand accounting issues that related to judgement. For the Audit Committee the scale, scope and complexity of the company created challenges. The Audit Committee needed to be concerned with the culture of the organization, the risk management procedures in place and the internal control environment. The complexities of International Accounting Standards (IAS), the fair value accounting issues in financial services, were difficult issues for the Audit Committee.

56. The ACC said that the board was dependent on the auditor and that the non-executive directors in particular relied on the auditor to ensure that the information they were presented with was accurate and fully reflected what was going on in the business. It was important to engage with the auditors and have regular discussions. The Audit Committee looked to the auditors to provide advice on the culture in overseas locations, the risk procedures and limits in place, how errors were escalated etc. The auditors were an important source of information for the company management and the board.

57. The ACC saw part of his role as to protect the auditor on big judgemental issues, although he noted that this had not been necessary at the company. He needed to ensure that PwC was not being hit too much on fee (and likewise that internal audit was not being hit on headcount). It was important to have a relationship with the auditors that was based on trust. He said that in any constructive relationship there would be disagreements and the auditors could do a better job if supported by the Audit Committee.

Management

58. The ACC had very regular contact with the CFO and Company Secretary. He met the senior finance team to discuss papers prior to Audit Committee meetings. He also met the CEO regularly through his role as the SID.

Shareholders

59. He said that meeting shareholders in his role as ACC was rare. As Chairman of other listed companies, he often met shareholders that were common to more than one company. For example, common shareholders might come to him in his role as Chairman of [✂] but also discuss the company at the same time.

60. The ACC explained that the Chairman, Head of Investor Relations and CEO had the main contact with shareholders. The SID might be called upon if there were concerns about the CEO or Chairman and it would be rare for the ACC to be called on by shareholders.

Regulators

61. The ACC spent time meeting with regulators (FSA, SEC, the Federal Reserve) and discussing the audit, both internal and external, with them.

Resolution of audit issues

62. The auditors (internal and external) were cleared to contact the ACC at any time they wished. See also paragraph 16 regarding the company's formal procedures.

Auditor selection

63. In the four years that the ACC had been on the board, there had been no 're-proposals' by PwC for the audit nor had there been any tenders.

64. There was an annual review of PwC's performance (as noted in paragraph 17). This asked questions regarding the technical skill of the auditor, the resources available, the speed of response, the coverage of their approach, the speed of delivery, the quality of regulatory reporting, the fee etc. In addition, the company looked to ensure that it received an appropriate level of benefit from the auditors in terms of the qualitative observations that they could make to management regarding cultural, competency or succession issues around the world.

65. The ACC looked for:

    (a) high technical competency;

    (b) good level of commercial understanding and ability; and

    (c) reasonable price from a market perspective and one which reflected appropriate audit efficiencies.

66. In addition, there was a review of PwC's proposed audit partners when the five-year audit partner rotation requirement was due. The ACC was involved in interviewing suitable partners, and the selection required his agreement. The company agreed on appointing a senior partner as AEP, who had the ability to influence and control PwC resources globally, as well as a supporting partner with strong technical expertise (obtained via experience of auditing banks in the USA).

Potential to switch

67. For a bank in particular, switching auditor would be a huge exercise and had a huge risk associated with it. Switching auditor would be a major disruption to the company and would divert significant amounts of management time. More importantly, the ACC considered that the risk of audit failure was higher when an auditor was changed. He referred to the empirical research undertaken by Bocconi University. He said that this was not to say that companies should not switch audit firms, but that for complex organizations (such as the company) it was an enormous task that needed to be undertaken effectively.

68. Before the company reached a point of seriously considering switching auditor, it would first speak with the Senior Partner of the audit firm to explain any concerns and ask for them to be addressed. The ACC could exert pressure on the audit firm to maintain quality and appropriate fees but was mindful of the risks of switching auditor. The ACC considered that if there was a situation where he said that he felt it was necessary to go out to tender, then this would happen. As ACC, he could insist on a tender.

69. The biggest trigger for a switch would be where the company thought that the quality of the team being allocated to its audit was not adequate and that over a period of

time the audit firm had not responded to the company's needs and complaints. For the ACC, fees were a secondary issue. The most important factor was quality.

70. The ACC said that considering a mid-tier auditor for the company would be irresponsible. Whilst in the UK he thought there were high-quality mid-tier firms, this was not always the case in other countries. The ACC expected that the mid-tier audit firms would not want to audit a bank as the work was too high risk. The legal risk to audit firms of auditing a bank was high and required significant staff resources (both training and numbers). In addition to traditional auditing skills, non-audit skills were required to undertake a bank audit and so a strong multidisciplinary firm was essential.

71. The ACC anticipated that pitching for the company's audit would cost an audit firm in the region of £2–£3 million and that the company's management would devote significant time to the process. In addition, the independence requirements for the SEC added significant hurdles to switching auditor.

72. The ACC did not consider that all the Big 4 audit firms could undertake the company's audit globally. In the UK, there were two other firms (in addition to PwC) that could be asked to quote for the audit. For the company there were likely to be two and a half to three options (these were PwC and KPMG and perhaps Deloitte), based on the firms' global bank audit experience. The ACC noted that EY provided significant non-audit services to the company but he did not consider it a significant player in the global bank audit market.

Fee

73. As noted in paragraph 69, fee was not the ACC's primary concern. He explained that during the financial crisis the auditors were on call continuously as there were numerous worldwide regulatory investigations: the auditors' input to these was huge. The company needed the auditors to provide their best people and for them to give up weekends and holidays: this was not an appropriate time to debate fees. As a result, fees (particularly in 2008) were high for legal and audit. In addition to PwC's input, Deloitte and EY had been used to provide specialist advice (as the company did not want all the work to go to its auditors).

74. The ACC said that it was clear to PwC that in calmer times when the environment was more stable, the fees paid by the company needed to be comparable with other banks and investment management businesses, and that they needed to reflect appropriate audit efficiencies.

75. Management looked at the hourly rate charged and the number of hours taken by the auditors and these were challenged. The ACC said that PwC knew only too well that the company could tender and so there was a dynamic mutually respectful relationship. There was more pressure on fees today than there was two years ago.

Quality

76. The ACC did not review the audit file but considered that he was able to assess the quality of the auditor by:

(a) reputation of the firm;

(b) the Financial Reporting Council (FRC)'s AIU reviews;

(c) the Public Company Accounting Oversight Board (PCAOB) reports (although these were less timely); and

(d) annual feedback on the effectiveness, support provided by, and competency of, the auditor from the company's business units.

77. The ACC said that when the company made a major acquisition in the USA [✂] it had met with senior management of the network and arranged for the quality of the audit team there to be improved. The company saw this as a massive acquisition that needed 'an A team' from the audit firm.

78. The company wanted to make the Annual Report more meaningful for its shareholders and so it provided an ACC's Statement that detailed the areas the Audit Committee had spent time discussing, the areas of concern and the core areas of judgement. This provided more useful information than the audit report itself, but was underpinned by the auditors' work. This additional disclosure had to be tempered with a view of disclosures that were too commercially sensitive to publish or disclosures that might expose the company to litigation on judgements taken in preparing the accounts. The ACC considered that at the moment auditors could not provide this detail due to legal and accounting reasons.

Financial crisis

79. The ACC considered that a lack of focus on financial stability by the FSA and Bank of England, and their failure to recognize issues associated with increased gearing and off-balance-sheet vehicles, were the drivers of the financial crisis. However, he said that risk management policy, credit rating agencies, remuneration policies and auditors also had a role to play. In his view (as someone who had been an auditor of a bank and as a director of a bank that had been audited), the auditors were the longstop of the system rather than the slip catcher. The ACC said that there had been such complexity that people on all sides had not been aware of what was happening. His view was that the auditing profession had declared victory too soon and that, particularly in relation to off-balance-sheet items and sub-prime lending, more questions could have been asked.

80. The role of IAS and fair value accounting was also an issue. IAS did not cause the crisis but the requirements exaggerated banks' positions both in good and bad times. As an example, the ACC explained that previously auditors would require general provisions (in the accounts) to cover losses on loans but under International Financial Reporting Standards (IFRS) this was not allowed until the loss was realized. This meant that bonuses were paid out on profits that had not been realized.

81. IFRS had made it more difficult for the auditors to use judgement and there had been a move away from a 'true and fair' (principles)-based approach to a compliance (rules)-based approach. Accounting for financial instruments under historic cost accounting was complex enough and under fair value accounting it had become an exercise that was too intellectual.

82. Auditors were in a difficult place when it came to auditing a bank—issuing a qualified opinion would have wide and dramatic implications. Confidence was vital to the functioning of a bank. In many jurisdictions, regulators would not allow a qualified opinion and they would be engaged to find practical solutions well before a qualified opinion was issued.

Non-audit services

83. The ACC's personal view was that there should be much stronger restrictions on the provision of non-audit services by auditors. He was in favour of a prohibition of non-audit service provision by the auditors. He considered that there were audit-related services that it was appropriate for the auditors to provide. These were where the auditors had the knowledge to undertake the work efficiently without compromising independence.

84. The ACC considered multi-disciplinary firms to be a benefit as non-audit skills were required to complete audits, but considered that for individual clients the auditor's main responsibility was the audit itself and the relationship was healthier where it only provided the audit.

Other—choice

85. There was limited choice of auditor due to independence requirements. The ACC considered limited choice to be undesirable for the capital markets and unhealthy. The Mid Tier firms needed to build expertise and capabilities (probably through non-audit services) to enable them in the long term to fill this gap. The ACC considered that a prohibition on non-audit service provision by auditors might help facilitate mid-tier firms' growth. The ACC noted that when there were six big firms perhaps only four of them could audit a global bank audit, so the restriction on choice in bank auditing was not entirely new.

The AEP's view

86. The AEP [✂] joined Coopers & Lybrand in [✂]. The AEP had been the lead partner on the audits for a variety of FTSE 100 clients and now the company. In addition, he had been involved as a partner in the audit for a number of other major companies, albeit not as the AEP.

87. The AEP had also been a member of PwC's governance bodies in the UK and internationally. He had sat on the PwC Assurance Executive Board with responsibility for the 'top-tier audit sector' (ie FTSE 100/200 companies). The AEP had also held senior positions at the Institute of Chartered Accountants in England and Wales.

88. He had been the lead AEP on the company's audit for three years (including the current one for 2012). The company's audit was one which auditors aspired to lead.

Coordinating the PwC team

89. The key audit team comprised (in addition to the AEP) a further eight partners who had responsibility for: the group (alongside the AEP); the principal business clusters and, within them, the teams in the principal countries as well as IT and controls; and tax. There were then more partners involved in leading the work in other countries. The lead AEP was required to rotate after five years; the other partners mentioned were required to rotate after seven years. This meant that in each year there was generally at least one partner rotating.

90. In addition to the partners in the UK, the audit would require more than 100 staff for the group audit and main divisional audits, [✂], and at least a similar amount for the investment bank audit [✂], and a similar number for the teams in the principal countries overseas. There were also many more staff around the key locations across the globe. [✂] The total headcount for the audit would run into the hundreds.

There was a restriction on senior members of staff working on the audit for more than ten years but it was rare for non-partners to reach the rotation limits as they generally moved on for reasons of their own career progression within this time.

Audit scope

91. The AEP said that the company's management had limited influence as to the areas PwC would investigate in conducting the audit. The scope of the audit was set by the AEP. It was discussed with management but, to take it to the extreme, the AEP could not accept any client requesting that a particular part of the business should not be audited. That would be a limitation of scope and would result in a qualification of the audit report.

92. However, occasionally a client might ask for an increase in scope. This was more likely to come at the request of the Audit Committee and would be likely to be an increase in emphasis rather than a completely new area of investigation. For example, if a client had recently started operating in a particular territory, the Audit Committee might emphasize their desire for the auditors to cover that in the audit plan.

Resolution of audit issues

93. It was important to flag issues quickly so that there was time for debate. The audit scope was planned and the timing of work organized to ensure that the areas where the risk of an issue was higher were addressed as soon as possible, so that anything that needed to be could be identified and reported in a timely way.

94. There was discussion and debate between local audit teams and local management to resolve interim issues. Anything that was not trivial was also raised with the group audit team and group management. Many issues would be resolved at the level of the partner for the particular business area. However, the AEP needed to ensure that group level issues were brought to his attention and that he was involved in the discussion and not just the answer. He needed to be prepared not just to sit there and receive what was presented but to be vigilant as to what he thought was important and he needed to be ready to 'dive to the bottom of the pond' if that was necessary.

95. Technical issues could be referred to a PwC technical team (either at an individual partner's choice or where PwC's view was challenged by the client). This could be on an informal or formal basis, where there was a panel of three or four specialists tasked with providing a consensus as the firm's view. A technical panel would typically be used where there was the prospect of qualifying an audit report or where there were concerns about going concern.

Relationships

Audit Committee

96. The AEP said that the Audit Committee members were all strong characters. He considered the ACC to be probably the most active ACC that he had ever dealt with, which was good. This was influenced by the ACC's background: he came from the audit profession and from running a large firm. The ACC by nature got stuck into problems, he was interventionist, he cut to the chase, was demanding and got involved in between Audit Committee meetings. It was clear that the auditors could always call him.

97. The ACC wanted a comprehensive audit, he wanted the comfort that a quality and thorough audit had been done, but he wanted issues synthesized. As a result, the reports to the Audit Committee were kept to 10–12 pages with a summary of points that the Audit Committee really needed to consider.

98. There had been no significant disagreements between the ACC and auditor. The AEP had taken issues to the ACC where he had warned the ACC that he needed to be cautious or needed to look in more detail. However, there had been no occasions where the auditor and management were still in disagreement by the time of the Audit Committee meeting. This was not to say that issues were 'served up'l; there was still debate with the Audit Committee.

Management

99. The AEP's relationship with management was different from that with the Audit Committee, as management were primarily involved in the decision-making and resolution of audit issues. The AEP generally met the CFO, GFC, CEO, other executive directors and finance management operating at the group level.

100. The AEP provided the following as examples of debate he had had with the CFO:

(a) regarding appropriate size of provision [✂]; and

(b) regarding appropriate disclosure in a preliminary announcement [✂]. Both were resolved prior to publication.

Shareholders

101. The AEP had no interaction with shareholders. He said that in his view, shareholders did not understand the role of audit very well and that the audit profession had not explained it well. His personal view was that if a way could be found to resolve the issues of not privileging one individual shareholder against another, then having a more open conversation with shareholders would be constructive.

Auditor selection

102. PwC's appointment as auditor was reviewed annually. Around 40 people at the company completed a questionnaire that scored senior PwC staff out of ten and gave qualitative commentary that reported on their perceived strengths and weaknesses.

103. The AEP said that he took this very seriously; he obtained the detailed feedback and worked out how to respond in the next year. The AEP's view was that any score less than 8 needed to be addressed:

(a) There had been a recurring issue on these forms that suggested PwC had not worked as well as it could with internal audit. This had now been addressed and had been largely a perception issue.

(b) The AEP was considering how to respond to other matters raised in the feedback received and planning actions accordingly. For example: [✂].

104. The Audit Committee had the final say on auditor reappointment. The AEP said in general that Audit Committees would look to management on this and if management wanted to change auditor then he would not ordinarily expect an Audit Committee to

go against this and vice versa. If anyone had reason to want to tender, then no one else was likely to say no.

105. The biggest risk to PwC's continued engagement was if PwC got the audit wrong and gave an incorrect opinion on whether the published accounts were true and fair. Other risks would be if the fee became uneconomical such that PwC was not making a proper return or if the client for whatever reason was not a good learning and working environment for PwC's staff. In terms of threats from competition, the AEP said that the FRC had made its intentions clear and that more tendering was likely to become a feature of the market. PwC had last been asked to repitch to the company in the mid-1990s.

Fees

106. The fee was negotiated by the AEP who would talk with the GFC, one of the managers in the GFC's team and a member of the company's procurement and strategic sourcing team. The AEP was supported by senior members of his team.

107. The difficulty of the audit had reduced by 2007/08 when there had been extreme market conditions. Some assets were becoming easier to value and there had been a number of disposals so the balance sheet had shrunk. There was no resistance from PwC to react to this, ie to reduce hours and reduce the fee. The AEP wanted to ensure that he did not waste shareholders' money.

108. In the AEP's first two years on the audit, there had been efficiencies that had resulted in the fee being reduced by £[✂] (in the context of at [✂] fee). Late last year the company had undertaken a cost reduction programme across the business. The company had asked PwC to find a [✂] per cent saving in one year. The AEP agreed to seek opportunities for a £[✂] ([✂] per cent) reduction over two years.

109. This was challenging. The savings previously identified by PwC were the result of individual areas of efficiency. To achieve the further reduction now contemplated, PwC had comprehensively reconsidered the scope of the audit in much greater detail. Achieving such reductions in such a complex business in a manner that was safe, compliant and still delivered quality would always be inherently difficult. [✂]

110. The AEP considered that there were other areas where costs could be reduced. He said that the joint audit in [✂] cost the company at least [✂] £[✂] million more than would be the case if PwC were the sole auditor. PwC had recommended to the company that this should be considered.

111. The AEP said that although he was always prepared to pursue opportunities to realize efficiencies in the audit process, he was not prepared to agree to reductions in fees being achieved simply by reducing PwC's rates and hence their profitability. He was satisfied that the pricing of the company's audit was not out of line with that of comparable clients. The AEP also said that he would worry about the motivation of the staff on his team if he accepted a fee that would lead to a very low recovery rate. The AEP involved the partner in charge of his business unit, and the relevant member of the Assurance Executive within PwC of the fee negotiations and how he thought he could deliver to that fee. [✂]

112. Fees can be benchmarked against other banks of the basis of the ratio of the fee to relevant published financial measures. The AEP said that different ratios for companies with different businesses could be understood on the basis of the difference in the degree of difficulty of the audit. If the ratios for the company were considered

against those of its peers with comparable businesses, the company was in the middle of the pack. [✄]

113. The Audit Committee had supported management's wish to see the fee reduced. PwC was not disputing this desire, but it needed to ensure that they were still able to carry out an adequate audit. The ACC had remarked previously that it would be better if PwC came up with the efficiencies themselves than have the company demand it. If it came to a point where the fee was too low to do a proper job, then the AEP would have to go to the Audit Committee and say so. The AEP felt that, in general, negotiating the fee was a management task and that if this could not be agreed without Audit Committee involvement then there was probably something else wrong with the relationship. Two sensible parties with a good working relationship should be able to negotiate a fee sensibly.

Quality

The Annual Report

114. The company's Annual Report included a report from the ACC setting out the key areas that the Audit Committee had discussed. The AEP reviewed this and in his view there was an implicit approval, as the auditor was required to report to the shareholders if the statements accompanying the audited accounts contained any factual inaccuracies or were inconsistent with those audited accounts. The AEP recalled making a number of suggestions on the last report which were taken up. The AEP welcomed proposals to make auditor sign-off on the written sections of Annual Reports more explicit.

115. In a project that ran from 2009 to 2010, PwC considered a number of areas where the audit could be reformed, including how the auditor could be more constructive and transparent in its reporting to shareholders. While the auditor cannot unilaterally change the standard form audit report, which is set by statute and regulation, it could try to persuade ACCs to report in more detail on the areas of discussion between the AC and the auditor. PwC's Chairman had included this recommendation in a speech in September 2010. The relevant PwC audit engagement partners discussed this with various FTSE 100 clients and six or seven had been persuaded. The AEP said that it appeared that many companies were reluctant to lead on this and wanted to see how shareholders and markets reacted to other companies making these disclosures. In the company's case, the ACC had been a front runner in the process of additional disclosure and the AEP said that he and PwC could not take credit for the additional disclosure in the company's report as this was company driven.

Professional liability

116. Potential damage to PwC's reputation and financial penalty through auditors' professional liability were risks of a low-quality audit. The AEP noted that whilst Arthur Andersen ultimately had won its case in the law courts, damage to its reputation had already caused the firm to collapse.

International requirements

117. The company was SEC-registered and this added to the work required from the auditors. There were additional disclosures that were required for the SEC, but the main issue was that the auditor had to work to two sets of auditing standards: International Auditing Standards and PCAOB Auditing Standards. In the case of the

PCAOB, the auditor had to make an explicit attestation to internal control in respect of financial reporting.

Regulatory inspections

118. [✄]

Value-added services

119. In terms of value added through the audit, PwC provided management and the Audit Committee with a document titled 'Control environment, audit findings and perspectives'. This was an evolution of the traditional management letter and reported both on the audit findings and views on internal controls and other observations that were more speculative [✄].

120. PwC said that as a broad categorization it would be fair to view the report in two parts with *(a)* the audit findings which were factors that needed to have been considered in order to do a proper audit and *(b)* the perspectives and observations which were less directly related to the audit opinion but were part of the audit service quality. Perspectives were something that competitors would also seek to provide and the quality of this document allowed PwC to provide a distinctive offering to the client.

121. The AEP explained that as a generality, audit was at risk of being perceived as simply a matter of 'financial reporting compliance' and as such was perceived to be less valuable. However, he disagreed that this should be the sole purpose of an audit and he believed that any audit team had a responsibility, to reflect on what they had observed in conducting their audit. This also made the job more interesting and rewarding for the staff .The additional time spent preparing one of these reports was marginal as the work had already been undertaken. If an auditor could not make any observations about the way a company was run, having audited it, then in the AEP's view it had not done the audit thoroughly enough. The local PwC teams talked to the relevant management committees within the company and so the overall document pulled together the areas and agenda items that had been discussed between PwC and those local committees.

Partner rotation

122. [✄] PwC was considering candidates to be the AEP's successor who would be able to meet the company's requirements and the AEP was seeking to do this in an orderly manner.

123. The AEP explained that in taking on the company's audit he had made the following changes:

(a) focused on refining the scope of the audit as the financial crisis receded;

(b) focused on integrating the work that the systems auditors did with the core audit work so PwC worked efficiently; and

(c) focused on the value add and insights that the audit team could provide to management and the Audit Committee.

Internal audit

124. [✂]

125. In general, if making use of internal audit the external auditor would, whilst planning the audit, set out a number of areas of discrete testing as a menu to discuss with the client. The internal audit team might then agree to undertake some of these areas but would be required to work to PwC's standards both in terms of procedures and documentation. PwC would review the work and would also undertake independence checks on the staff doing the work. It would be a 'direct substitution' of the company's time for the auditors but doing what the AEP wanted them to do. This could produce audit fee savings. The SEC requirements limited the reliance that PwC could place on internal audit.

126. The UK Ethical Standards limited the work that external auditors could provide in terms of internal audit (PwC provided no internal audit services to the company). If Internal Audit was purely a financial audit, then there would be less of a concern of self-review. However, most internal audit functions had a broader reach than just financial audit and so strayed into areas of management which clearly could not be performed by external auditors.

Auditors and the financial crisis

127. The AEP noted that he had only started auditing the company in 2010 and so he was not able to discuss the specific judgements made in 2007, 2008 and 2009. However, in general he felt that a large part of the criticism of auditors was due to a misunderstanding of the purpose of audit and in particular of the going concern assessment. The AEP said that auditors needed to take note and do a better job of explaining what the purpose of audit was. The audit profession had been too defensive. Auditors should be trying to meet people's expectations to the extent that they could.

128. He considered it naive to think that the financial crisis had not affected the way auditors thought about their work but that fundamentally audit was driven by an assessment of the risk of misstatement. In relation to banks, the most pertinent risks were the valuation of certain products in the balance sheet and the liquidity of the bank as an institution. He explained that valuation of some of the assets was very challenging. There could be cases where the company had a book of assets and nobody had completed a trade for six months. There was no observable market, so models were constructed and attempts made to tie them back to reality, calibrate, back-test it etc. The auditors took a view on how the bank's financial position might develop over the next 12 months given the current environment.

Non-audit services

129. The ACC had cut back the non-audit work that the company used PwC to provide. In the last year, the largest piece of non-audit work was for £4 million and related to provision of individual overseas tax advice for the company's seconded employees. This service used to be provided solely by PwC. Now new individuals were being referred to another firm, PwC's work would reduce over time. It was for historical reasons (continuity and relationships with the individuals) that it had any of this work. The rest of the non-audit services work was audit related, for example regulatory returns, security issuance letters, and bond offering documents (these are not technically classified as audit related but are work that generally goes to the auditor).