

STATUTORY AUDIT SERVICES

Summary of calls held with Company R

CC note

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

The company is a large bank, located in more than [X] countries around the world. One of the Big 4 audit firms, [X], had been the company's auditor for approximately [X] years.

Views of the Group Finance Director

Complexity of auditing the company

1. As an international bank, present in more than [X] countries with a number of divisions and with over [X] legal entities worldwide, the audit was both technically and logistically complex.

Tendering

2. The company recently stated its intention to conduct a tender for the external audit, with an appointment to be made for [X]. The tender process was initiated in light of the requirement to tender the external audit every ten years on a 'comply or explain' basis introduced by the FRC in October 2012. The process was instigated by the Group Finance Director (GFD) and the Chief Accounting Officer (CAO), and was discussed and approved by the Audit Committee (AC) and board as a whole before commencing. The GFD stated that had the UK Corporate Governance Code not been amended, the company would not have gone out to tender at this time.
3. The GFD thought the primary benefit of holding a tender was getting a better idea of the actual ability of the Big 4 audit firms rather than their perceived ability. Although the company had interactions with other audit firms around the world, a tender gave a more granular understanding of firms' capabilities. He did not think that the Mid Tier firms could act as auditor, given the company's complexity and international activities.
4. The process started in [X], when the company contacted the global Chairman for each of the Big 4 networks to submit an interest in being part of the tender within one month. [X]. The [X] firms were subsequently asked to provide statements detailing their experience and capabilities relevant to the company's audit.
5. The company had formed a tender committee comprising a number of different members of staff, including the GFD, the Audit Committee Chair (ACC), the Risk Committee Chair, the Chief Risk Officer, the CAO and the Group Head of Tax. There was no intention to use external resources to help run the tender process. The committee was in the process of collating information to provide the firms and deciding upon the selection criteria.
6. The GFD estimated that the tendering firms would be given access to the company over a two and a half month period. Meetings would be at the request of the firms, but the GFD expected these to be extensive in order to give the firms the necessary

understanding of the company in its key markets. He expected that the incumbent auditor would need to have fewer meetings. Audit firms would meet finance and accounting staff, risk staff and business leaders from the main global locations.

7. The GFD anticipated that after the firms had access to the company, final proposals would be made in [X], and after follow-up questions and interviews a decision would be made in [X], approximately eight months after the process was initiated.
8. The GFD thought that the monetary costs to the company of running the tender were not material. He thought that the level of disruption caused by a tender depended on the number of meetings requested by the firms, although this was likely to be relatively minor. The GFD considered that there was certainly an opportunity cost of the time spent running the tender, but that this cost, like any switching cost, would be borne through additional workloads of staff members engaged in and supporting the tender process. The tender had been initiated at this time to minimize disruption in the reporting cycle, but the overriding reason was to give the auditor the maximum amount of time to satisfy independence requirements. The GFD thought that, depending on the firm selected, ensuring independence could be very disruptive and very costly for both the audit firm and the company.
9. One significant challenge for the company was that any firm being appointed as auditor would need to undertake 'cleansing' of the senior management of the firm, any partners in the same office as the Audit Engagement Partner (AEP), the engagement team and any member of staff spending more than 10 hours on providing non-audit services to the company. This cleansing would include the need for the relevant partners and staff to close any credit arrangements with the company. Such a process could take some time.
10. The company was undertaking a cost/benefit analysis, and this was running in parallel with the tender process. It did not currently have any quantitative analysis of the costs and benefits of the tender and possible switch.

Switching

11. The company's consolidated group accounts comprised more than [X] legal entities in more than [X] countries and a significant proportion would require their own statutory audit opinion and would thus potentially incur switching costs.
12. The GFD stated that the process for transitioning to a new auditor, should they choose to switch, would be likely to be a similar but much expanded and more detailed version of the tender process, since each overseas audit firm would need to meet key local staff in a number of areas of the business to understand local accounting, controls and processes, and products. In addition, the AEP and senior members of the group audit team would need to visit and meet senior bank staff at group, regional and business levels.
13. The GFD believed that some of the preparatory work would be conducted in [X], the final year of the incumbent's tenure, but the majority would need to be during the first part of the new auditor's first year. The GFD did not want to have two separate audit teams disrupting the business and from past experience believed that the new auditor shadowing the previous auditor did not work.
14. The cost of switching amounted almost entirely to the staff time spent educating a new auditor. However, the regulatory environment and necessary compliance culture of the company meant that this was a cost borne by individual staff members through additional workload during the tender and transition processes.

15. The GFD expected that the increase in time spent with an incoming auditor would be significant but this would last only for the first year of the engagement. If it lasted longer than this, the GFD would consider this to indicate that the wrong auditor had been chosen. However, the GFD believed that the costs of switching would be borne primarily by a new firm as the AEP and staff would need to invest a significant amount of time getting up to speed. As the company reports quarterly, the first 12 to 15 months of the engagement would give insight into the auditor's performance.
16. The GFD did not think that the tender and potential switch would necessarily achieve a significant reduction in audit fee. His key concern was to ensure the quality of the audit provided by any new firm.
17. Some of the firms (and/or other firms in their respective networks) had significant banking relationships with the company and there would be a potential cost to the company of losing this banking work.

Remedies and other comments

18. The GFD thought that a policy of open book tendering would be very hard to make happen as audit files contained confidential information regarding the company and the company's customers and would need significant protection.
19. The GFD thought that there were barriers for audit firms outside the Big 4 in terms of the size and complexity of certain companies. The GFD had been approached by a Mid Tier firm seeking to act as a 'second auditor'. The GFD's opinion was that joint audits did not work—the second auditor often lacked experience and did not add to the work of the primary auditor and, from experience, resulted in a less efficient and effective audit .
20. The GFD's opinion was that the engagement of both the ACC and AC as a whole was detailed and robust at the company. He thought the ACC should not be the main point of contact with the auditors as, first, this would make it a more executive role, and second, the ACC would not have time or the operational knowledge of a company to fulfill this role.
21. The GFD thought that enhanced shareholder–auditor engagement could be productive. He also thought it would be difficult to coordinate shareholder appointment of auditors.
22. The GFD also thought that the Audit Quality and Review team (AQRT) would need to be upgraded significantly in order to be effective. He gave a comparison of the difference in resources employed by the AQRT and Public Company Accounting Oversight Board (PCAOB) in relation to the company, with the FRC review conducted by one individual, whilst the PCAOB's review was conducted by a team of around eight individuals, despite the UK element of the company being significantly larger than its US operations.

Views of the Audit Committee Chair

Complexity of auditing the company

23. As an international bank, present in [✂] countries with a number of divisions and with over [✂] legal entities worldwide, the audit was both technically and logistically complex.

Tendering

24. The ACC said that the decision to tender was driven by the introduction of the FRC rules requiring companies to tender every ten years on a 'comply or explain' basis. He thought that there was a general drive to increase levels of tendering given external pressures about perceived 'coziness' and the financial crisis—given this external pressure he thought that just explaining seemed unacceptable. However, in his view this perception was unfounded because audit partner rotation brought sufficient change to ensure independence. He saw little other reason to tender as the company had been very satisfied with the audit service that it had received.
25. Having decided to tender, the question arose of when to tender. The company faced the rotation of the lead partner in 2015, and the tender was initiated to coincide with this event. The company had started the tender process early in part because there were not many firms that could audit a large bank—to make the process effective it wanted the Big 4 firms in the tender and wanted to make sure that these firms were not involved in tenders for other banks and thus ensured that the best team would participate in the tender. The decision to go early was driven by management. The proposal was made to the ACC first and then to the AC as a whole and then to the board.
26. The ACC also discussed whether audit firms auditing a competitor restricted the number of firms the company could invite to tender. His view was that the risk of 'information leakage' was highly unlikely and he did not view it as a problem, although he acknowledged that there may be a perception issue and others might not be so comfortable. It was an issue that would be discussed. A more significant issue would be if a firm had sufficient staff with appropriate expertise to service more than one large bank.
27. The ACC faced no investor pressure to conduct a tender. He had not been approached by investors about the audit and was not aware that any members of finance team had been approached either.
28. The ACC thought that up until the time a company decided to switch there were no significant company costs associated with holding a tender. From the company's perspective, it needed to make certain individuals and data available to the audit firms so that they could tender in a knowledgeable way (and that this knowledge could translate through to the actual audit). There was no benefit if there were surprises in the process. This took time and effort, but it incurred no additional costs, and it was relatively easy to cope with the opportunity costs. In contrast, the ACC thought that audit firms would have significant costs of preparing a tender.
29. In terms of his own time commitment, the ACC thought he would 'make the time regardless'. His role would not be to facilitate meetings and provide data, but ensuring a thorough process. His time would be spent reading the written submissions of firms (limited to 30 pages), and holding half-day meetings with the selection panel (for each firm), followed by analysis and discussion by the selection panel in order to arrive at a decision. The ACC estimated that the selection panel would spend up to two weeks' work on the tender process.
30. For the company, the ACC considered that the opportunity cost arising from staff undertaking the tender would not be quantified and staff (both financial and senior general management) would 'make time regardless'.

Switching

31. If the company were to switch, there would be a huge amount of work, particularly for the finance function and general management to get the new auditor up to speed and answer their questions. The new audit firm would need to have access to the outgoing auditor during the 2014 audit in order to be prepared to take over in 2015, incurring extra expense for both. It was unclear currently who would bear this extra expense and how much it would be. Staff in the bank would absorb the work into their day-to-day activities. The ACC noted that in the bank 'if something has got to be done, it gets done'.
32. Other tangible costs associated with switching auditor related to the rules regarding business arrangements with the new audit firm, for example partner pension/investment arrangements and any provision of funding to the incoming audit firm. All these arrangements would have to be undone to ensure independence, and this could be extensive and complex.
33. The ACC thought the benefits of switching auditor were extremely hard to quantify. A new firm would bring a fresh pair of eyes and there was a chance it might come to a different view, but this was highly unlikely to be on a material issue. The ACC thought that by using a Big 4 firm, the company would get the same level of technical quality, and given the external regulatory scrutiny of audit firms, the possibility of a 'revelation' (ie that a new auditor would uncover a material issue that had been overlooked by the incumbent) was extremely remote.
34. The ACC thought that the appointment decision would require careful explanation if the company decided to stay with the incumbent. The company would need to assure investors and regulators that they had conducted a rigorous process and concluded there would be no benefit from making a change. There could be a perception that the tender process should lead to change regardless, to reinforce auditor independence.
35. Ultimately, in deciding whether to switch there were essentially three questions that needed to be answered. The first was which firm would provide the best service and thus the greatest benefit to the company and its shareholders; the second was what the cost (financial and operational) of switching would be; and the third was how would the market and investors react if the incumbent was reappointed given their length of tenure.

Remedies and other comments

36. Regarding mandatory tendering, the ACC was already treating the new FRC guidelines as mandatory, given his view that explaining was not sufficient. He also thought that companies of a similar scale and stature would want to be seen to be doing what the regulator prescribed. However, he thought that if the switch turned out to be a lengthy and difficult process, the company might wish to explain for a while in future. The ACC thought that more frequent tendering might lead to a more efficient process over time, but could not be sure.
37. The ACC did not favour mandatory rotation as, given the company's size and complexity, and the amount of audit work required, the switching of audit firms could be too frequent, leading to inefficiency and additional cost.
38. The ACC read the Audit Quality and Review (AQR) report relating to the company's audit firm and discussed it with the audit team. He thought that these reports were perhaps a better way of dealing with concerns over independence than changing

audit firms. He thought that part of the benefit of the AQR was that it existed as a deterrent. There could be value in increasing the frequency of company reports to five years to match partner rotation, therefore there would be a report at least once in the tenure of each partner.

39. The ACC was happy with the removal of Big 4 clauses in loan documentation, although this was something of which he had no direct experience.
40. The ACC said that the AC was involved in agreeing the audit fee but it was driven by the Finance Director who conducted the key negotiation. As there were often changes in scope in the company's audit, it was necessary to negotiate the fee regularly. The ACC's role was to ensure that the fee was sufficient to uphold audit quality. He thought that the auditor had a high degree of accountability to the AC—as ACC he always met the audit partner and senior manager before AC meetings to discuss issues and this took place in private without executive management present.
41. Some issues that could be included in extended auditor reporting (such as key issues during the audit, decisions on certain accounting judgements) were included in part already in the accounts. The ACC had a concern that any additional reporting would likely be closely monitored by legal advisers and would trend towards a standard format. This would lessen its value to shareholders.