

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Note of meeting held with Mr Nick Land

CC note

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

Mr Land is a former Chairman of a Big 4 firm (Ernst & Young) and is now Audit Committee Chair (ACC) of four major multinational companies: a British multinational telecommunications company, listed on the London Stock Exchange and a constituent of the FTSE 100; a London Stock Exchange listed aviation services company within the FTSE 250; a London Stock Exchange listed investment management Group; and a privately-owned health and beauty products company.

1. As a former chairman of a Big 4 firm and in the early part of his career an audit partner and now a member of the Financial Reporting Council (FRC) and the ACC of several companies, Mr Land saw the issues raised in the Competition Commission's (CC's) Notice of possible remedies from several angles. He considered that the provisional findings and possible remedies were headed in the right direction without being too extreme. However, he was concerned that the CC had been overly critical of the performance of ACCs and had portrayed Chief Financial Officers (CFOs) as somewhat untrustworthy people in collusion with the auditors.
2. Mr Land recognized that this had not been the CC's intention. He recognized that some companies in the lower echelons of the listed market and AIM¹ which had limited resources, smaller boards and not always robust governance processes could present particular challenges for auditors and Audit Committees (ACs). It was important for the CC to articulate this division among listed companies.
3. Mr Land observed generally that corporate governance of UK-listed companies was much improved. He also noted that whilst there might be control weakness from time to time the use of more sophisticated IT (such as enterprise resource planning systems), stronger internal audit functions and more robust governance meant that, in reality, there were few major control issues in the larger companies, but this was not necessarily the case lower down the main market, and that the experience of auditors of mid-market companies would be different to those of the largest.

Tendering and switching

4. Mr Land sensed that there was a real momentum for tendering at present, that the FTSE 350 would comply with the Corporate Governance Code Requirement to tender every ten years and that there would be many early adopters. He was aware of several boards that had decided to initiate tenders, without yet informing the incumbent auditors of the decision, and believed this trend would accelerate. Some big banks had indicated that they would issue tenders providing sufficient notice to allow market participants to assemble suitable prospective audit teams.

¹ AIM (formerly the Alternative Investment Market) is the London Stock Exchange's international market for smaller growing companies.

5. In Mr Land's experience, tenders were an effective way of getting audit firms to improve their approach. On one occasion, he had re-tendered an engagement with just the incumbent firm and it was striking how this had stimulated a radical look at the way the firm planned and undertook the audit.
6. Mr Land believed that the historic low level of tendering was partly due to management reluctance and perceived switching costs. ACs also took comfort from five-year partner rotation. He said that, from his previous experience as an AEP, companies found that switching auditor was less disruptive than expected and that the transition to a new audit firm could be relatively painless. He disagreed that, if well planned, switching necessarily gave rise to significant costs. Some audit firms were skilled at minimizing such costs and they would continue to improve in this area as the instances of tendering increased and ACs developed more streamlined tendering processes.
7. The increased momentum of companies going out to tender was part of a wider general accelerated evolution of governance in the UK under the 'comply or explain' model, which Mr Land strongly supported. The impetus had partly come from outside events, including the CC investigation, but it was a fair comment that CFOs had probably had too much influence in the past over the appointment of auditors and this had inhibited tendering. In any tender, the ACC and AC should have clear ownership of the process and the decision, even if the CFO was responsible for the project management.
8. In Mr Land's view, non-audit services (NAS) provided by the auditor—a legacy of the past when auditors provided companies with almost all services—should be banned. In recent years non-audit fees earned by auditors had reduced substantially. The continuing practice of awarding an auditor some NAS, eg tax, damaged the image of the audit industry and the perception of independence.
9. From his perspective Mr Land's biggest fear stemming from increased tenders was fee lowballing. As an ACC his first priority was to have an audit of the very highest quality and within bounds the cost was not relevant. He had some expectation that the audit firms would recognize that very aggressive price competition could be counterproductive.

Increased frequency of Audit Quality Review team reporting

10. Mr Land believed that the information the Audit Quality Review (AQR) reported annually on the firm level controls and systems (the 'tone from the top') of each major audit firm was important and of value to ACs as, of course, was an individual report on an audit.
11. How to measure the quality of audit was a key issue for ACs. While some areas of a company's audit were very visible to the ACC and the AC, others were opaque, although an ACC could do more to increase knowledge of the opaque areas by asking the auditor to provide a detailed explanation.
12. More frequent engagement-level reporting on these areas by the AQR could give some comfort, although Mr Land would like to see more emphasis given to oral examination of the AEP, rather than just scrutiny of the audit files. He believed that audit files were only part of the evidence on quality; a good audit file did not necessarily indicate a good audit, as what was on the file might not necessarily reflect the level of challenge to management or the scepticism exercised by the auditor. But he nonetheless acknowledged the importance of ensuring proper documentation and

compliance with International Standards on Auditing (ISAs); clearly a poor audit file was unacceptable.

13. Mr Land identified that some aspects of the US Public Company Accounting Oversight Board regime, such as interviewing AEPs to establish their understanding and familiarity with the key audit judgements and how these were reached would add greater value to the AQR process.
14. Mr Land questioned if the focus on a standard set of themes for all audit files reviewed in a given year by the AQR added greatest value, and whether more focus should be given to the key audit risks for each company's audit.
15. Reporting might also be improved if the AQRT:
 - spent more time looking into the audit firm's internal quality controls (principally the firms' own cold reviews), helping raise the quality of the cold reviews and in due course being able to place reliance on them if considered adequate;
 - spoke more to the ACCs; and
 - spent more time with the non-Big-4 firms, and reported more frequently.
16. In response to a suggestion made by the CC, Mr Land considered that it could be helpful for the AC to comment on AQRs in its report to shareholders. However, the legal framework around the AQR's work and the ability to make such disclosures would need to be considered.

Strengthening the role of the AC

17. Mr Land said that he kept abreast of the key issues throughout the audit and that the AC would be kept up to date with the progress of the audit and in particular the resolution of the key issues. It started with the AC's approval of the audit plan setting out material areas of audit risk. The identified areas of risk, including any new ones that emerged, were reviewed throughout the audit at the regular AC meetings.
18. In a well-run year-end closing process and audit, the final year-end closing meeting between the auditor and the CFO should be something of a non-event, since the discussions about key issues were an iterative process during the audit. However, if a significant audit issue had been identified and resolved in collaboration with the CFO during the audit, the ACC and AC needed to track it and know how it had been resolved. He would do so in his direct discussions, outside the AC, with the CFO and auditors as well as through feedback during AC meetings.
19. Mr Land said that the detail with which he understood the auditor's approach on a particular area of the audit varied according to the level of risk and the complexity and visibility of the particular issue. For instance, the AC would have a lot of visibility of an impairment calculation and how the auditor had audited it, However, he gave the example of revenue recognition in one company as one area where he did not have full visibility about the way the auditor tackled this area. ISA 240 included a (rebuttable) presumption that there was a significant audit risk over revenue recognition, which in the context of this particular company's operations was not an audit risk that he perceived to be particularly great, but he recognized that he did not have a complete understanding of what the auditors were doing. He thought that in future, so as to understand this issue, he might do a 'deep dive' on it and spend an hour or so in detailed discussion with the auditor to address this.

20. Work as the ACC for one particular company took up some 15 days (or part-days) of his time in addition to time as a board member more generally. But an ACC could have to devote far more time than this during a period of company crisis. Mr Land believed that there was a variation in the time commitment that different ACCs were expected to, and did, offer, and the time required varied considerably between companies, dependent on their size, complexity and issues.
21. Any CFO would want to manage the day-to-day relationship with the auditors. The question was how he or she did so and how the CFO related to the ACC and the AC. Although the audit firms might see the CFO as their key relationship, the balance of influence was shifting towards the ACC. More frequent tendering would strengthen the ACC/auditor relationship since the AC would clearly own the process. It was nonetheless important that the ACC and CFO maintained a non-adversarial, professional relationship, and that the CFO's views were taken into account. However, from Mr Land's viewpoint as an ACC, his most important professional associate was not the CFO but the lead audit partner.
22. There was a danger with some of the possible remedies suggested by the CC that the ACC could move into a semi-executive role, taking decisions unilaterally. It was important not to undermine the non-executive functions of a unitary board. The idea that the ACC should negotiate auditor fees held that risk, although Mr Land could see that holding that role would make it clear who the paymaster was.
23. During an audit tender Mr Land would favour leaving the negotiation of fees to the last stage of the tender process, which would mean that the primary focus of the competition would be on the quality of the offering of the audit service, rather than on fees. He believed that some recent tenders had adopted that approach.

Improving investor engagement

24. Mr Land could recall only one instance of an investor contacting him about audit (the inquiry related to non-audit fees), despite having sat on a number of boards and ACs.
25. He regarded the principle of improved investor engagement as important for the audit industry and for improved stewardship. At the moment the audit report was binary and in most instances was not worth reading. Investors therefore did not have a 'hook' on which they could ask questions about the auditor or the audit. One way of facilitating engagement would be to expand the audit report ([X]). Depending on the way investors reacted to such moves, further measures might be devised to build on them.
26. Mr Land noted that many institutional investors used proxy agencies to exercise their votes for all but their largest holdings, and that engagement with proxy agencies had been difficult. Further, he understood that a significant proportion—perhaps 40 per cent—of shares in FTSE 350 companies were owned by overseas entities and individuals, which made investor engagement even more difficult.

Other issues

27. Mr Land expressed concern that the audit service line of the Big 4 firms in the UK could become a 'minority sport' given the continuing significant growth in their advisory and consulting services. Revenues from the statutory audits of listed companies' engagements represented a small and decreasing part of their total revenues (perhaps in the range of 15 to 25 per cent) and if this trend continued it was

possible that the larger firms' commitment to their public interest audit role could be diminished.

28. Mr Land commented that he disagreed with the CC that the provision of NAS was not an issue of concern, and believed there should be a total prohibition to avoid any perception of a loss of independence, but believed that the work that the CC had undertaken on NAS, in the specific context in which it was examined, was fair (ie that there was not an indication of loss leading on audit engagements to win NAS).
29. Mr Land was not an enthusiast for joint or shared audits, believing them to be inefficient and holding the risk of some matters 'falling through the cracks'. He thought the CC was correct not to pursue this as a remedy option.
30. He believed there was little chance that second-tier firms could develop to challenge the listed audit practices of the Big 4 firms, without a massive global shake-up. The emergence of the former Big 8, now a Big 4, had been market-driven. In the seventies and eighties, so as to meet the needs of major multinational clients, they had merged with many of the best national firms around the world. It was now too late for the second-tier firms to take a similar route. Mr Land nonetheless agreed that the greater number of new tenders could stimulate some efforts by these firms to expand their capabilities, but he doubted that the dominance of the Big 4 would be significantly eroded.
31. The risk of one of the Big 4 firms collapsing was not an impossibility although extremely remote. The firms were acutely aware that a very major reputational scandal in a major part of their network, coupled with civil or criminal charges (for instance action by the US Department of Justice), could quickly result in their collapse. He believed that a collapse because of an overwhelming legal claim was extremely unlikely because such an action would be drawn out over many years and there would be time for the authorities and the firm to find a restructuring solution.