STATUTORY AUDIT SERVICES MARKET INVESTIGATION

BlackRock

Background

1. BlackRock had a large index investment business that invested in quoted companies all around the world. It also had an active investment business (the 'fundamental equities' business) and we spoke with two senior fund managers, [✂] (the Investors), from this part of the business who focused on the UK market. The fundamental equities business held concentrated portfolios where active decisions were taken to hold certain stocks.

2. BlackRock had significant investments in six of our case study candidates, [Company A] [✂], [Company B] [✂], [Company C] [✂], [Company E] [✂], [Company G] [✂] and [Company H] [✂], with investments ranging between 3 and 10 per cent. The investments at the lower end were likely to be held by the index investment business and where there was more than around a 4 per cent shareholding was where the Investors had actively chosen to purchase a stock.

Engagement with the audit process

3. The Investors had little engagement with the audit process. Insider dealing legislation limited the participation of investors: it required a distance between investors and the audit process. Accordingly, the Investors had no access during the account preparation or audit process (for example, the Investors were not allowed to see draft accounts). The Investors spoke to management and reviewed the accounts once they had been produced and published.

4. In the last five to ten years, the Investors had had no specific interaction with Audit Committee Chairs at any of the companies in which they had invested (neither investments in the case studies nor otherwise). The Investors relied on the Audit Committee and the other board committees to represent their interests as shareholders. The Investors had more interaction with the Remuneration and Governance Committees. BlackRock had a Corporate Governance team who assisted the Investors on matters relating to the structure of boards and the Investors were able to express views on the board composition and remuneration.

Shareholder influence

5. The Investors could not recall an instance when they had voted against a management recommendation of an auditor at an AGM (although they noted that they had voted against management on other matters). They explained that if there was an issue in relation to corporate governance, they would seek to influence management in advance of the AGM vote. An issue in relation to the auditors would be unusual. They had not sought to try to cause a tender or switch of auditor.

6. As BlackRock typically did not hold more than 15 per cent in any company, it was not a controlling shareholder and so the scale of its investment (as noted, between 3 and 10 per cent in our case study companies) did not affect its approach to corporate governance and the choice of auditor. The Investors explained that in certain situations (for example, in a takeover situation) a company might contact the largest six

shareholders to seek their opinions. They could not recall this situation occurring in relation to choice of auditor.

Reliance on audit reports

7. The Investors relied very heavily on a company's published accounts, initially using the preliminary report and then updating their analysis with the full accounts once they were published. The Annual Report was the principal source of financial information. The Investors focused on the accounting policies explained in the report and on ensuring that they understood the differences between the Cash Flow Statement and the Income Statement. The audit opinion in itself was not their key area of focus and information, unless it was unexpectedly qualified.

8. The Investors said it was unlikely that they would invest in a business with a qualified going concern audit opinion. However, they explained that BlackRock's index fund would invest in such a business if it formed part of the index, and that other types of investor might actively choose to invest in companies with a going concern qualification. If the Investors were already shareholders in a business whose accounts were then qualified, this would not necessarily cause them to sell their shares as this was likely to occur in particular economic environments or perhaps where the Investors wanted to participate in a rescue rights issue. The qualification of the accounts in itself was not a trigger, as the Investors expected that they would already have identified and understood the particular issues the relevant company faced.

9. The Investors considered it to be too strong to say that they had ever 'relied' on an audit report to their detriment. There would, of course, be occasions where they had invested in a company and subsequently there had been unexpected issues. However, they were not really relying on the auditors, as history did not suggest that this was a good idea (see paragraph 12). As an institutional investor, whilst they hoped that the accounts were properly audited, the opinion issued was not the primary determinant in any investment decision. The audited accounts were only one factor in any decision to invest.

10. The publication of the accounts could promote a buy or sell decision if the information published was different from that expected by the Investors. A going concern qualification would matter and the auditor's view on this was of interest.

Reputation of audit firm

11. The Investors said that today the identity of the auditor was unlikely to affect their decision to invest due to the concentrated pool of auditors appointed to provide auditing services to FTSE 350 companies. However, ten years ago the identity of the auditor had been an issue as there were some companies in the FTSE 350 who had unrecognizable auditors. Where the auditor's name was unrecognized, this led to further questions and scrutiny of the investment case. As an example, the Investors noted Versailles plc which had been audited by Nunn Hayward and was an example of a company that had grown very quickly and entered the FTSE 250 index. Versailles plc went into administration in 1998, and it later emerged that there had been a serious fraud. The Investors recalled that auditors Nunn Hayward had been disciplined.

12. The Investors' view was that recent large corporate failures (eg RBS, Marconi and Enron) had all been audited by Big 4 accounting firms and so the identity of an auditor was not something an investor could rely on. No audit firm could protect investors completely from a management team that stretched accounting policy.

13. The Investors could not recall the identity of the auditor at the companies they invested in: the identity was not significant to them.

14. The Investors considered that the quality of an audit depended on the quality of the individual audit partner completing the work rather than on the identity of the audit firm. The appointment of any particular firm of auditors was not a safeguard. It was not possible for investors to know the quality of the individual audit partner—whilst the audit partner's name was on the accounts, there was not a list of 'star' audit partners that investors could compare this to and rely on.

15. The Investors could name Grant Thornton, Baker Tilly and Stoy Hayward (now BDO) as audit firms outside the Big 4 (although Grant Thornton only due to personal experience in a non-audit capacity). They considered that there would be no issues with one of the top four to six firms auditing any of the companies in the FTSE 350. What the Investors wanted to see was that a firm with an established reputation to maintain was putting its name behind the accounts. They might be concerned if the proportion of revenue an audit firm was generating from one client was too high.

16. The Investors said that investors who focused on distressed, highly leveraged companies with chequered corporate histories might care more about the identity of an auditor than they themselves did.

17. The Investors noted that investors did expect to see a bigger auditor appointed as companies got larger, although they felt that the lack of use of non-Big-4 auditors stemmed from reluctance at board level and not from investors such as themselves.

Tenure of auditor

18. From the Investors' perspective, a change of auditor had no impact and largely went unnoticed. It was not therefore in itself a cause for concern except *in extremis* where the audit firm had resigned and put out a statement highlighting particular concerns. Likewise, a company having an auditor for a long time would not concern the Investors. They said that whether having the same auditor for a long time was best practice was an open question but in itself it would not affect their decision to hold shares.

19. The Investors said that it was right to look at instances of change as a possible risk, as they would view frequent change of auditor as an issue, particularly if the CFO also changed numerous times in a short period of time.

20. Changes in accounting policy were much more important to the Investors than a change in auditor. The Investors were looking for 'clean' accounts by which they meant accounts where they could easily understand the accounting policies applied and reconcile the Cash Flow Statements to the Income Statement. The choice of auditor was not relevant.

21. The movement of a company from AIM to the main market was often associated with a change of advisers including the auditors (eg bankers, brokers, lawyers). This did not concern the Investors; they invested in businesses irrespective of the market that the business was listed on and so in their view there was no specific need to change auditor when changing market.

Specific changes of auditor in the context of our case studies

22. The Investors explained that BlackRock's investment in [✂] [Company A] was only held as part of the index fund business at the time of the switch of auditor from [✂] [one Big 4 auditor to another] and so they did not have a view on this switch as this was not an active decision to switch.

23. With regard to the other changes of auditor in the case studies, they had no recollection of the events as they did not focus on the identity of the auditor of the companies they invested in (see paragraph [13]).

24. By way of example, the Investors said that they had previously had more significant shareholdings in [✂] [one of the case study candidates], but had sold their shares when the company's activities had got more complex and started to undertake more activities in more territories and made more acquisitions. The sale of shares therefore had nothing to do with the choice of auditor and was more a concern that the management team could not address the increased complexity of the business.

Audit fee

25. The audit fee was not a relevant factor in the Investors' preference for investing in a company. The fee was unlikely to be a determining factor in terms of a company's profitability. The Investors expected company boards to control costs.

26. The Investors read the note in the accounts setting out the fees earned by the auditor split between audit and non-audit fees. They did not like to see a high degree of non-audit work and if observed, they would want to understand the reasons behind this. The Investors did not want to see an 'unhealthy dependence' on the audit firm.

27. The Investors did not see the size of the fee as a sign of quality, rather as a sign of complicated accounts.

Audit quality

28. The audit opinion in itself was not what the Investors relied on as it was binary (ie qualified or unqualified). It was the application of accounting policies that mattered to the Investors, particularly in relation to:

    (a) Cash Flow versus Income Statement;

    (b) provisions;

    (c) what costs had been capitalized;

    (d) acquisitions and disposals of businesses; and

    (e) tax paid in cash versus the tax charge.

29. The Investors said that whilst it was difficult to assess exactly how items had been treated (and to get certainty), they were able to gain an impression of whether the accounting treatment was prudent or not. They then relied heavily on this impression. The Investors saw the Cash Flow Statement as a cleaner (ie more straightforward and direct) indication of what the company was actually doing and compared it to the Income Statement. They would then seek to understand differences between the two statements. The audited accounts provided them with flags to alert them to potential

issues and areas which they could then explore in further detail with management if appropriate (for example, they could question management around changes in accounting policy, or the rationale for capitalizing certain items).

30. The Investors expected the auditors to provide a strong element of objectivity whilst understanding that a set of accounts was never wholly objective (as the application of some accounting policies was subjective). The auditors were there as a 'counter-weight' to the subjectivity, and sometimes creativity, that management might seek to apply.

31. Initially the Investors considered audit to be 'helpful at the margin' to their investment decisions as ultimately it must be helpful to have someone independent review the accounts. On further reflection, the Investors revised this view and said that for a long time the audit had 'been taken too much for granted' and that as long as the auditor was independent, the audit was 'critical' as it was always there. They considered the audit firm's reputation to be important as a backstop. The Investors clarified that they were not suggesting that audits did not need to be undertaken.

32. In considering what an 'ideal world audit' might provide, the Investors considered that, as today, a 'true and fair' view was what they would look for. They did not consider that all fraud could be detected through even the very best audit processes. Further information that the Investors would have liked to see was an explanation of the differences between the Cash Flow and Income Statements. A discussion of the areas that management and the Audit Committee had debated most would also be helpful.

33. The Investors did not hold auditors accountable for issuing unqualified going concern opinions in advance of the banking crisis. They considered that investors in general had information on the levels of risk that assets were classified under and that investors should have made their own assessment as to whether the leverage was too high. Assets were classified into one of three categories under the accounting standards and it was for investors to judge if there had been an increase in a particular class that concerned them. The banking crisis arose for many reasons and audit was only a part of that. To judge if there was an audit failure, the Investors would need access to audit files. It was not an area to which they had given material consideration. They also considered issues of rogue traders in banks to be an internal audit or risk management failure, rather than an example of external audit failure.

34. One of the Investors expressed a personal view that more competition might lead to a 'softer' audit as firms sought to win clients by agreeing to adopt more aggressive approaches to accounting policies as ways of improving profitability for management. Whilst Audit Committees might be an adequate constraint on this, the Investors had no direct access to observe the effectiveness of any of the non-executive directors. The Investors noted a concern that unbridled competition in a regulated market might not always be good.

Independence

35. The Investors noted that non-executive directors were considered not to be independent after nine years and could see an argument that there might be a case for auditors changing after 'n years', but they had not found auditor independence to be an issue at any of the companies in which they invested.

36. In terms of board composition, they would be concerned if the entire Audit Committee was composed of former audit partners from the firm conducting the audit, but they had not seen any examples of this. The general principle of auditor independence

was very important to the Investors. The BlackRock Corporate Governance team focused on the independence of boards.

37. In theory, a group of talented individuals could set up their own audit firm and compete in the market but the Investors would be very concerned if a small firm depended on a small number of large clients. They felt the independence rules appropriately restricted this.