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Competition Commission's Insight on FDs and ACCs

Audit Review

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Lawrence trained as a Chartered Accountant at the London office of Deloitte. He moved to another top 10 firm where he progressed to Group Audit Manger and then Marketing Director. In this latter role he wrote that firm's audit tender manual, trained the partners in audit tender approaches and supervised all large audit tender responses – giving him a special insight into the other side of the audit tender process. In his career as a consultant he has assisted many professional firms in responding to tenders, developing tender response protocols and managing the tender of professional services for organisations like J. Sainsbury, The Institute of Chartered Accountants in England & Wales and the National Pharmacy Association.

This special insight into both sides of the tender process enables Lawrence to quickly prioritise the key attributes required from a prospective service provider and provide a robust critique of the responses received.

Lawrence is a Fellow of The Institute of Chartered Accountants in England & Wales, a Member of the Chartered Institute of Marketing and The Institute of Consultancy, and a Certified Management Consultant.

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Introduction

The Competition Commission's enquiry into Statutory Audits has involved in-depth qualitative and quantitative research[1]. Because this focused on Finance Directors or equivalent (FDs) and Audit Committee Chairs (ACCs) their divergence of opinions is a fascinating bi-product of the results. This paper explores the nature and extent of this divergence in four crucial areas:

1 Audit quality vs. cost

2 Assessing audit quality

3 Influence in auditor selection

4 Auditor selection criteria.

It highlights the FDs focus on cost, efficiency and operational aspects against the ACCs governance role focussing on audit efficiency, quality of the audit team and reliability of accounts. While FDs are less bothered about the audit report and want a smooth audit the ACCs see conflicts and challenges as a potentially healthy sign.

Is this a wasteful conflict or useful counterbalance ensuring better governance? And, should the divergence narrow or expand as more ACCs focus on stronger governance and greater adherence to the FRC's Code?

This paper argues that divergence creates the proper counterbalances that large businesses need and that, in the next few years, these differences in emphasis may grow as FDs focus on financial performance and ACCs focus on stronger governance. All stakeholders should broadly take comfort that ACCs are acting as guardians of their interest, whilst FDs are looking to maximise financial performance.

[1]A detailed survey of Finance Directors (FDs and CFOs) and Audit Committee Chairs (ACCs) of large listed and private companies was undertaken in October 2012- http://www.competition-commission.org.uk

1 Audit quality vs. cost

There is a hypothetical optimum audit scope. Sub-optimal work will run the risk that material financial misstatements and fraud are not detected while additional work may give greater assurances but will result in increased audit fees. Recent FRC investigations into auditors' work[2] highlight some reservations about the use of judgemental sampling and setting materiality… both of which require fine judgement and will affect both cost and scope.

[2]The Audit Inspection Unit, now the Audit Quality Review Team of the Financial Reporting Council

In the current commercial climate audit fees have been under great pressure with many fixed for a number of years after audit reviews. An increase in fees would have to be supported by a strong justification for an increase in scope and work. The second highest trigger for changing auditors is a substantial increase in audit fees. 71% of FDs consider that it is 'very likely' or 'likely' that a substantial increase in audit fees will be a trigger while a third of FDs consider it 'very likely'. This was less important for ACCs: 55% of ACCs consider that it is 'very likely' or 'likely' that a substantial increase in audit fees will be a trigger while only 19% of ACCs consider it 'very likely'.

The FDs are more focussed on cost. While ACCs are aware of fees they are less likely to trigger a change. Increased fees might be justifiable, and even desirable by ACCs and shareholders, if they feel they are improving quality and assurance.

The FDs commercial focus is further reflected by the fact that 65% consider price to be 'very important' or 'important' against only 44% of ACCs.17% of FDs considered price to be 'very important' contrasting sharply with ACCs at 7%. This clearly shows that ACCs are less concerned about price than quality and assurance. This is a contentious point but over-aggressive fee negotiations may risk the auditor cutting corners and reducing audit scope.

The flip-side to cost is efficiency and 91% of FDs and ACCs identified audit efficiency as 'very important' or 'important' but 46% of FDs considered this 'very important' against only 38% of ACCs. This highlights the FDs focus on more operational aspects and the clear implication that a more efficient audit will be reflected in lower fees. The ACCs are more concerned that too great a focus on efficiency may trim down the scope and reduce assurance.

2 Assessing audit quality

Complacency is perhaps one of the greatest risks leading to failure to spot material error and fraud. It is often manifested in over-reliance on management representations and an inability to refresh the audit approach. It was the highest scoring issue for triggering auditor change. 86% of FDs considered it 'very likely' or 'likely' that complacency of the auditor will be a trigger (44% considered it 'very likely'). This was even more extreme among ACCs: 94% of ACCs consider that it is 'very likely' or 'likely' that complacency of the auditor will be a trigger while 58% of ACCs consider it 'very likely'. Exactly how firms assess quality and spot complacency is not clear and FDs and ACCs differ in the factors they consider most important. This is particularly evident in four areas:

- auditor independence
- detecting misstatements in the accounts
- high degree of auditor challenge
- reliability and usefulness of audit report.

Auditor independence

There has been considerable focus on the issue of auditor independence in recent years: new rules on partner rotation, the recent EU Commission proposal for mandatory firm rotation and increased shareholder interest in non-audit fees. The Competition Commission's research does not show unanimous support for this issue. 91% of FDs identified independence as 'very important' or 'important' but only 69% considered it 'very important'. In contrast, 95% of ACCs identified independence as 'very important' or 'important' with 84% considering this to be 'very important'. The ACCs governance role comes into focus here with a greater emphasis on importance.

Detecting misstatements in the accounts

One surprising statistic, given that the introduction to the main International Auditing Standard requires the auditor to obtain assurance "whether the financial statements as a whole are free from material misstatement" was that only 87% of FDs and 95% of ACCs identified the ability to detect misstatements as 'very important' or 'important'. However, 81% of the ACCs considered this the be 'very important' against only 68% of the FDs. It is possible the FDs consider misstatement a more unlikely scenario, or place greater reliance on internal systems and Internal Audit, but the ACCs stronger position once again reflects their focus on ensuring that accounts presented to shareholders are materially correct.

High degree of auditor challenge

ACCs are looking for a high degree of challenge from the auditor with almost all of them considering this 'very important' or 'important' against only 81% of FDs. However, 64% of ACCs considering challenge 'very important' against only 37% of FDs who may see challenges as an implied criticism of their work requiring a diversion of resources to resolve; even if they are unfounded.

Reliability and usefulness of audit report

The main auditing standard states "The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements". But only 64% of FDs identified the reliability and usefulness of the audit report as 'very important' or 'important' against 79% of ACCs. And 46% of ACCs considered this 'very important' against only 29% of FDs.

The FDs are closer to the day-to-day business and view the accounts as an important reflection of performance but one that is historic and frozen in a moment of time; while the ACCs view the audit report as one of the main 'products' of the audit on which a large number of stakeholders rely.

3 Influence in auditor selection

It is generally agreed that ACCs and audit committees have the most influence in auditor selection. However, a fascinating and statistically significant result was that FDs consider themselves to have more influence in auditor selection than they are perceived to have among ACCs. FDs considered themselves 'most influential' in 28% of companies and the ACC and audit committee in 43%. However, ACCs considered FDs 'most influential' in only 14% of companies and the ACC and Audit Committee in 57%.

This should be of concern to the Financial Reporting Council, whose Guidance on audit committees clearly states "The audit committee is the body responsible for overseeing the company's relations with the external auditor". Institutional shareholders may be concerned with any inference that FDs may unduly influence their audit committees.

4 Auditor selection criteria

The ACCs generally placed more emphasis on expertise and quality issues against the FDs focus on factors that would lead to smooth management of the audit. However, the three criteria of most importance in the selection of auditors were shared:

Experience and knowledge of the audit partner and engagement team

Over 90% of FDs and ACCs identified as ‘very important’ or ‘important’ the experience and knowledge of the audit partner. The fact that 64% of ACCs considered this ‘very important’, against only 47% of FDs, reflects their mandate to ensure audit quality.

International network

The consistency of auditors’ international networks will have a direct effect on how they interact with international management teams and, where the audit fee accounted for outside the UK is greater than 40%, the strength of the international network is identified as ‘very important’ or ‘important’ by virtually all FDs but only 85% of ACCs.

Auditor reputation

The reputation of the auditor with investors, corporate brokers, analysts and external advisers is identified as ‘very important’ or ‘important’ for 84% of FDs and 82% of ACCs with little divergence in emphasis.

Conclusion

Overall, the current divergence in views between FDs and ACCs appears to reflect their different roles and priorities and provide a useful counter-balance ensuring good governance and effective use of external auditors. The constant trade-off between audit price and quality will continue to be very finely balanced and shareholders will increasingly voice opinions.

Assessing audit quality will intensify and become more formal taking a form similar to 'board effectiveness reviews'. These 'external audit effectiveness reviews' will provide independent and objective confidence that the audit is both efficient and providing the right level of assurances and may be used to properly support decisions to delay tendering.

Audit Review are specialists at providing this type of effectiveness review and provide the necessary resources and expertise for the Audit Committee to fulfil its obligations. Even if you are not ready for a review or tender at the moment it might well be worth talking to us about your strategy and how we might help in the future.

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