PCAOB Public Meeting on Auditor Independence and Audit Firm Rotation: Views from a buy-side analyst

Comments by James Alexander

Head of Equity Investment Research at M&G Investment Management

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Summary

- Auditor rotation, good in principle
- Problem with size
- Conflicts of interest
- Value of audits
- Financial company audits, especially banks

Auditor rotation

- Rotation of auditors is a good idea in theory, but not particularly important.
- Trust in management is much more important.
- Boards should have the responsibility for auditor rotation.
- However, we do have a bias in favour, and would like boards to explain more their choice and reasons for not rotating.
- Serious problem with lack of choice in auditors

Problem of size

- Giant companies are very time consuming and hard to analyse, and audit
  - smaller companies are quite difficult to as well
  - but at least there is a feeling one knows them better at the end of the process.
- The "agency problem" becomes more acute in giant companies as the companies become so much bigger than the individual investors.
- Giant companies require giant auditors, and giant investors. Where will it end?
- Problems from size, echoing the banking TBTF debate

Conflicts of interest

- These firms are not particularly transparent
  - 50% to 75% of revenues from non-audit sources
  - A surprising situation
- Best paid staff are in non-audit roles
- Non-audit growing very fast, audit revenues stagnating, therefore challenges increasing
- Recognition that most non-audit fees are from non-audit clients

But …

- Will make it tough for them to switch as auditors to non-audit firms without heavy loss of group revenues

The value of audits

- Audit fees as a % of revenues, expenses or market capitalisation are very, very low
- If the value of something is measured by its price then how valuable are external audits?
- At the end of the day it comes down to whether you trust the agents, the management
- There are simply too many numbers to check and analyse, by auditors or investors
- Fair value accounting applied to financial companies is particularly, and terrifically, challenging given the lack of liquidity of most of the balance sheet

Financial company audits

- Financial companies are very hard to analyse and audit and regulate
  - Many incredibly complex models for b/s items and p&l
- The implied guarantee of banks by sovereigns, means the onus is much more on the regulators than the auditors for the soundness of those companies
  - This follow on from them being "authorised" to carry out their business and having satisfied the regulators in terms of capital adequacy
- Therefore, the regulatory process and regulatory accounts need to be at least as scrutinised as the audit process
- For banks, in some sense, audits don't matter