COMPETITION COMMISSION

STATUTORY AUDIT SERVICES

Summary of calls held with Company K

CC note

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

The company first switched auditor in [✂] from one Big 4 firm to another (from [✂] to [✂]). The company more recently switched auditor again in 2011, switching back to the original Big 4 firm.

Views of the Chief Financial Officer

Complexity of auditing the company

1. Given that the company operated in a regulated sector, it required three different sets of accounting: one following UK GAAP, one following IFRS and one following guide-lines specified by the regulator ([✂]). The company had very little overseas business to be audited—the majority of this was sold off in [✂]. leaving a few remaining tax liabilities around the world.

Tendering

2. The company conducted its tender using its internal procurement function. This helped apply structure to the process and made sure the company adhered to the relevant rules. The input of the finance team established what the company's requirements were.

3. Having established its requirements, the company considered all eight firms listed on the Achilles procurement database for external audit services (a general procurement service giving a seal of approval to suppliers). Of these, only the Big 4 firms chose to tender.

4. The Chief Financial Officer (CFO) thought that all the Big 4 firms were capable of auditing the company, but there were differences in the offers of the firms. The fee bids were in a range of 60 to 110 per cent of the previous audit fee. The CFO discounted one firm ([✂]) as, although the cheapest, it was the least competent of the firms and the CFO was not prepared to accept that level of quality despite the lower fee. He discounted another firm ([✂]) as it was more expensive than the incumbent auditor ([✂]) and the now current auditor ([✂]), but offered the same level of quality.

5. The CFO thought that there was very little to decide between the two remaining Big 4 firms. He recommended the incumbent—he thought the incumbent lead partner had more in-depth knowledge of industry issues and that it would be easier not to go though the transition to a new auditor. The difference between the firms was mar-ginal, and the CFO thought that it was right to test the market every so often. However, the company decided to switch auditors, and appointed the remaining Big 4 firm ([✂]).

6. As a result of the tender, the company received a 30 per cent reduction in fee which was fixed for three years. The CFO thought that this was worth the opportunity costs associated with the tender. He commented that tendering put the most intense pressure on fees. Without a tender, a reduction of perhaps 5 to 10 per cent might be available.

7. The CFO estimated that he spent approximately three to four days of his time on the tender process, with the procurement team spending a similar amount of time and his Financial Controller a bit more time. There was virtually no effect on the wider finance team during the tender process—its time was spent during the transition to the new auditor.

8. The CFO was almost surprised at how much the audit firms wanted to audit the company, given that there were non-audit service projects worth more than the audit fee itself. One of the firms submitted a bid for the audit while it was working on a more lucrative two-year project for the company.

9. Generally speaking, the CFO was surprised that other companies did not tender more often as there were incentives to do so. He thought it problematic that there were only four big audit firms (the market had been more competitive when there were eight), but he did not think there were any barriers to switching—he thought that a lack of tendering among other companies was down to laziness.

Switching

10. The CFO expected that the transition to the new auditor would be painful, but he was still happy to tender and go through this process for the fee reduction the company achieved. The transition process was less intensive than the CFO had expected, in part because he did not take into consideration the knowledge the new auditor had of the company.

11. The new auditor had some familiarity with the company as it had audited the company approximately ten years ago, and the lead partner had been part of the old audit team. The CFO also thought it had done its homework well. While he had had doubts about one member of the audit team, that person had been replaced.

12. The CFO did not incur any additional time costs in the first year after the switch—he had the same meetings he would have had with the previous auditor. The education process for the auditors was facilitated by the wider finance team. The CFO estimated that 10 to 15 members of the team were involved, spending a couple of hours each. Regarding the new audit firm getting up to speed, the CFO thought the company made it easy for them by pointing out the key issues, noting that the new audit firm had not found anything substantial in addition to these risks.

13. There was a similar level of audit quality after the switch of auditors, but the CFO thought that the new auditor had a more accessible style of reporting than the previous auditor. He also thought that in its second year audit, the new auditor was becoming more efficient, spending less time at the company and reducing the number of hours spent on the audit. The CFO resisted a request to increase the fee (in spite of the fixed fee agreed during the tender), and commented that the new auditor had done its learning in the first year and by decreasing its hours in the second year allowed it to increase its return.

Remedies

14. The CFO supported a policy of mandatory tendering but thought that the tendering period should not be too short. He thought that holding a tender every five years was about right given the company's regulatory cycle (under which [✂] companies must submit plans to [✂] every five years for approval), but was not in favour of mandating this time period as there could be other issues affecting a company (for example, merger and acquisition activity) that made holding a tender not feasible. The CFO was strongly against mandatory rotation of audit firms as this could result in a situation where the company had to switch away from the audit firm that was best placed to perform its audit.

15. He favoured an expanded remit and/or frequency of Audit Quality and Review team reviews, but only if this did not incur excessive cost. He thought there was merit in conducting these reviews at companies lower down in the FTSE index and conducting them more frequently (for example, every three years).

16. The CFO was strongly against strengthened accountability of the external auditor to the Audit Committee (AC). He thought that as things stood, all audit issues were presented to the AC and that this remedy would lose all accountability of the CFO if the auditors were agreeing accounting treatments with the AC.

17. He did not think enhanced shareholder–auditor engagement was necessary. In his experience he had not heard shareholders wanting more engagement with the auditors, and if they did want more engagement they could have it. He gave an example that during the course of many meetings with portfolio managers or heads of equities there was never any desire to speak to the auditors—they took the numbers as read.

18. Regarding extended reporting requirements, the CFO did not think that the auditor's statement should 'add value'—it was the threat that the auditor might add a qualification to the report that was important.

Views of the Audit Committee Chair

Tendering

19. The company intended to tender because it was not completely satisfied with the audit service it was receiving, but due to changes in the shape of the Group, and an appointment of a new CFO, the combination of risks associated with switching auditor earlier were too great and the tender was delayed. The company made its concerns known to the incumbent auditor and the service did improve following the rotation of the audit engagement partner (AEP). However, the timing of the strategic refocus of the group also made it an appropriate time for an audit tender process.

20. Cost saving was not a primary driver for going to tender because the cost of the company's audit fee relative to its turnover was very small. The company's audit fee was approximately £[✂]. Nevertheless, the Audit Committee Chair (ACC) told us that the opportunity to benchmark standards and price was a relevant consideration.

21. The company operated in a regulated industry, making it necessary for any contract procurement to follow certain defined steps. The tender process was managed by a team of seven to ten employees taken from the company's internal procurement team and its financial team.

22. Only the Big 4 audit firms were invited to tender because none of the Mid-Tier auditors had sufficient experience in the company's particular industry. The ACC told us that the more specialized the industry, the more likely it was that the Big 4 auditors would be the only suitable candidates.

23. Each bid was marked on a quantitative basis against 40 to 50 criteria by the tender team. The ACC agreed the selection criteria at the beginning of the process and joined the final interviews, with his view added on top of the existing work. Two auditors ([✂] and [✂]) were marked very closely and, therefore, their bids were presented to the AC members for further discussion.

24. The ACC told us that nine years was long enough for an incumbent auditor. In his view, a tender provided an opportunity for other auditors to 'put their best foot forward' or encourage the incumbent to 'up its game'.

25. The ACC told us that he would recommend going to tender every five to ten years and, if possible, at the same time as the AEP is switched. He pointed out that it would be useful to have some flexibility in the mandatory tender time frame because the tender date may not fall at a convenient time for the company. He told us that the company had delayed tendering for its audit contract by approximately 18 months while it concentrated on its strategic repositioning.

26. The ACC estimated that his involvement in the tender process ran to approximately three or four days in terms of time spent, with two of these days spent during the final interviews.

27. He did not consider that the tender process presented a major disruption for the company as, although the company was large, it only had one main head office where the audit work was concentrated. He pointed out that the position may be different for a multinational organization.

28. With respect to choosing a new auditor, the ACC told us that he would have been happy to accept any of the Big 4 firms but chose the auditor he considered would be the best fit for the company. In the ACC's opinion, the primary duty of the auditor was to review and the sign the accounts. A secondary duty was to provide feedback on the company's financial control environment but this was an added bonus because there was an existing in-house risk team in place to analyse this.

Switching

29. The proposals received from the Big 4 were similar in scope. The proposed fees from the tendering firms were largely similar, although one firm put in a bid perhaps 30 per cent higher than the others. Any differences centred on house style.

30. The ACC told us that no formal cost benefit analysis was undertaken by the company. In his opinion, any costs and risks of switching related to weighing up the benefits of building a new relationship with an auditor (eg obtaining a fresh set of eyes) versus choosing the path of least disruption and remaining with the incumbent.

31. The ACC told us that an incumbent would generally be at an advantage if it was a good performer. The costs of going to tender were all internal and related to staff time. He told us that appointing an auditor was not a strategic issue and there were many more important issues for the company. He told us that the Big 4 had always been very good.

32. The tender resulted in a cost saving of approximately 30 per cent (or perhaps 20 per cent on a like-for-like basis because the company had shut down a couple of subsidiaries) (see paragraph 6 above). However, the ACC reiterated that cost was not the key driver for change given the small size of the audit fee versus the overall turnover of the company.

33. The number of extra hours spent by the new auditor in its first year had a negligible impact on the ACC. He spent a few extra hours working with the new auditor. There was no dip in the quality of the audit in the first year and the newly-appointed auditor hit the ground running because the partner had experience of the company's industry.

34. The ACC told us that both the old and new auditor got to the same place, but he preferred the reporting style of the new auditor. The new auditor had not uncovered any new issues, but was a little more active in additional work (which had been promised as part of the tender).

35. The ACC told us that it was made clear during the tender that the appointed auditor would be unlikely to obtain other work besides the audit from the company unless it was in better position to do so, ie it made sense for the newly-appointed auditor to complete the statutory and regulatory accounts for the company.

Comments on proposed remedies

36. The ACC commented on Remedy 6 of the CC's Remedies Notice which was intended to reduce the influence of executive management. The remedy would require the AEP to report directly to the ACC such that only the AC and the ACC would be able to negotiate audit fees, initiate tenders for audit work, require a replacement of an AEP, authorize the external audit firm to carry out any non-audit assignments or conduct any other major aspect of the external audit relationship.

37. The ACC said that he considered the remedy unnecessary because the ACC could already bypass executive management and talk to the AEP, if necessary. The ACC told us that he considered it would not be sensible to put the negotiation of audit relationships solely in the hands of non-executive directors because they did not have the same in-depth knowledge of the company as the executive management. Moreover, the executive management already had a fiduciary duty to the company.

38. The ACC did not see any problems with increasing the regularity and scope of Audit Quality Reviews.

39. With respect to increasing shareholder engagement, the ACC did not consider that the appointment of the auditor was high on shareholders' priority list. The ACC thought companies would be better served if shareholders were better engaged in analysing company strategy and reviewed the accounts and director remuneration.

40. The ACC said that there was a general lack of shareholder engagement because shareholders often only held shares in the short term and did not have a long-term interest in the success of the relevant company. This was in part due to the emergence of 'index traffic' where shareholders did not choose the shares they bought but held them as part of an index investment.