STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of calls held with Company L

CC note

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

Company L is a global company with five main areas of operation. It was audited by a Big 4 firm ([✂]), which was reappointed during a tender in the last five years [✂].

Views of the Chief Financial Officer

Experience at current company

1. The Chief Financial Officer (CFO) thought that the company was a very complex audit. It had hundreds of statutory entities and was very active in mergers and acquisitions—over the last several years there had been numerous acquisitions. The company had recently sold part of the business [✂]. The core audit took place at shared service centres (SSCs) in the UK and [✂], North America, as well as at headquarters and a large region not served by a SSC.

2. The CFO was not part of the tender process, having joined the company shortly after the event. To his knowledge the background to the process was that the company wanted to make sure its fee reflected market conditions. There had been a change to the shape of the business, and the incumbent had been in place for five years and there had been a number of audit partner rotations.

3. In his view the tender was a 'quick and dirty' process—only two firms (the incumbent [✂] and another Big 4 firm [✂]) were invited and there was not a full tender, no oral presentations were made. In some respects it was a management-driven process to reduce the audit fee. The company was successful in this regard, achieving a fee reduction of approximately 35 per cent.

4. Following the tender and his arrival at the company the CFO was not happy with some of the reporting treatments and thought the control environment was not as strong as it should be and that the audit fee might have been pushed down too far.

5. The CFO thought that as a matter of 'good housekeeping' a company should change audit firm occasionally. In relation to audit partner rotation he thought that new partners were working with the existing management and audit team and that if there were differences of view in relation to treatments or controls it was hard for an auditor to go back on his or her firm's previous work.

6. The CFO thought that conducting a tender was not very resource intensive—it was bringing a new auditor up to speed that incurred the most resource cost. A tender process at the company would likely be run by the Group Financial Controller with input from the CFO and approved by the Audit Committee Chair (ACC). Producing the required initial documentation for prospective audit firms would take a significant amount of the finance team's time for a few weeks.

7. The CFO discussed the company's choice of audit firms. He thought for large publicly traded companies (and especially for mid-caps and smaller companies) only the Big 4 firms were good enough based in part on reputation and in part on market expectation. Both equity and bond market expectations were relevant. For any potential tender, the company would invite those Big 4 firms that did not have conflicts of interest.

8. One Big 4 firm ([✂]), was currently working with the company to install a new finance system and earning a large fee and therefore there was an immediate conflict of interest. On a wider point, the CFO thought that three firms might be enough to hold a competitive tender, but until the company had the new finance system in place it would not be able to tender as first the finance team was busy, and second the company would not be able to define precisely the scope and process of an audit.

Previous experience

9. The CFO was previously CFO at another company with a listing on a non-UK exchange ([✂]) for approximately five and a half years, where he experienced a switch of audit firms.

10. The background to the switch was that, in the CFO's opinion, there were a couple of complex accounting issues at the company, which were reviewed by the regulator ([✂]). When the regulator said that one of the accounting treatments was wrong and that the accounts should be restated, the Audit Engagement Partner (AEP) conceded to the regulator rather than defending the accounting treatment, which the CFO felt undermined the credibility of the company's accounting. This led to the regulator encouraging the company to tender.

11. Following the next audit cycle (so as to avoid an audit change immediately after the initial public offering), the company tendered the audit and switched audit firm. As part of the tender process the audit firms were asked their opinions on the two potentially controversial accounting treatments. All firms which tendered agreed that the proper accounting treatments had been used. The company appointed a Big 4 firm ([✂]) as it offered a similar fee and it was a good idea to change. The CFO was surprised when the new auditor questioned one of the accounting treatments it was asked about during the tender.

Remedies and other issues

12. The CFO described switching auditor as an 'extremely painful process' as an audit depended on lots of relationships between different individuals. He thought that in relation to switching the majority of time costs were borne by the finance team, and that despite these costs, switching was 'something you had to do'.

13. The CFO thought that the administrative load on the ACC and finance teams was already high, and that the job of the Audit Committee (AC) was huge. He thought that everyone involved in the audit process was aware of the focus on audit quality. Anything that could be done to bolster audit quality should be encouraged. He felt that there was room for the UK to improve in this respect, but encouraged reinforcing existing self-regulation mechanisms rather than creating new reporting requirements.

Views of the ACC

14. The ACC explained that the global structure of Company L was complex. It operated in some 30 countries and comprised hundreds of legal entities. Its transactional

intensity was high; over 100 acquisitions and divestments had been made since 2008/09. It was currently in the process of digitalization and was installing new financial systems. [✂] The changing nature of the company provided an underlying rationale for an auditor to take a fresh look at the company's strategic position and management, although organizing a tender on top of all the other corporate changes was a considerable challenge.

15. The developing demands of good governance also indicated that it was right to re-tender the engagement so as to test the market. The incumbent at that time [✂] had been in position for seven years [✂].

16. However, the catalyst for the timing of the tender was the company's concern about the rising level of fees relative to the service provided. It was the finance department therefore that instigated the tender process, although the ACC was consulted before it was launched.

17. Some trade-off arrangements were discussed with the incumbent before proceeding with the tender, but the company remained convinced that it would not learn enough about the market without running a tender.

18. The global reach and complex operations of Company L meant that only a Big 4 firm could audit it. All the Big 4 firms had global capacity but not all were equally skilled with regard to digital and media developments. Mainly for this reason only one other firm ([✂]) was invited to tender.

The costs of tendering

19. The ACC said that he had some earlier, less direct experience of tendering for, and switching, auditors before Company L's recent tender. [✂]

20. [✂] and the outsider [✂]) helped limit the timeframe, and the tender process took no longer than six months. It involved intensive internal discussions throughout the process within the AC, within the management and financial functions and between the ACC and the CFO. Discussions were necessary with the two bidding firms to enable the outside bidder to become familiar with the company and its systems (including the new financial system and to enable both bidders to produce information documents to cover the issues in which the company was most interested.

21. The ACC said he would not describe the process as disruptive but it had taken away bandwidth from the CFO and staff at a time other changes in the company were being made. Some financial assets had consequently had to be refocused, despite some efforts to time the process to coincide with the cyclical activities over the company's financial year.

22. In hindsight, the ACC would have preferred to have had a broader process with different aims, based more closely on good governance considerations. [✂]

23. The ACC said that the role he played during tender was not markedly different from his normal role, although there was a greater specificity in the role during a tender. However, the ACC's role never involved just rubber-stamping.

Switching

24. The ACC acknowledged that there might have been some inclination towards caution and taking particular care during a time of great flux at Company L, but a change in auditor was never precluded and the company would not have embarked on the tender had that been the case.

25. As with the holding of a tender, a change in auditors was painful, mainly because it affected 'bandwidth', particularly in a complex company, diverting staff attention from other important matters.

26. The biggest risks of a switch arose for a new auditor's lack of familiarity with many aspects of the company, such as: a company's systems and controls, which might be unique to that company; the regulatory requirements of different companies and jurisdictions, which varied widely; and the particular interplay of financial systems across multiple countries and companies.

Possible remedies

27. On mandatory tendering, the ACC said that such a provision should not be inflexible. If no discretion was allowed, having mandatory tendering could affect how a company planned its acquisitions or changed its functional and reporting system. Broad guidance would make better sense; a ten-year period between tenders seemed reasonable; a significantly shorter period could raise difficulties.

28. The ACC was doubtful about the general proposal to strengthen the role of the AC. The nature of the AC's work was fairly time time-consuming. It was of critical importance to good governance. Any further responsibilities placed on an AC, such as additional reporting requirements, would be difficult and detract from the AC's bandwidth. The suggestion that the ACC might conduct fee negotiations raised particular practical difficulties. The financial management needed to know, on a day-to-day basis what was going on and who was doing what. An ACC would not have the degree of knowledge to fulfil that role. The self-regulation of an AC, so as to ensure its work was transparent and clear, made the best sense as a means of strengthening its position.

29. The ACC was a growing job, with a real downside to it; careful thought had to be given to any addition to its workload by increasing reporting requirements and giving it new functions. Such changes would make the ACC role more fraught with risk and would affect the willingness of people to take on the task.

30. On enhancing the shareholder-auditor engagement, the ACC considered that giving shareholders a choice of auditors would not necessarily lead to better decisions. The choice of auditors was an extremely complex and nuanced process. The ACC also thought that other suggestions for greater shareholder engagement, such as investor forums, would divert activities from other necessary functions.