STATUTORY AUDIT SERVICES

Summary of calls held with Company O

CC note

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

Company O is a British multinational company active in over 50 countries. The company has a primary listing on the London Stock Exchange and is a constituent of the FTSE 100.

Views of the Chief Financial Officer

1. Although the Chief Financial Officer (CFO) had taken up his role at Company O a considerable time after the company's last tender for an external auditor ([✂]), he had had some experience of tendering for, and switching, auditors earlier in his career—[✂].

2. On joining Company O, the CFO had initiated a 'very soft' tender. This had been cost driven. The company thought its audit fees were high for a company of its size (comparisons of audit fees were regularly published in a business magazine; [✂]). Having spoken to other audit firms, however, the company decided against proceeding to a full tender. The gain would not have been proportionate to the cost. The primary consideration for the company was to receive assurance that its auditor would get the accounts right, and in this respect there was not a wide differential between the Big 4 firms, all of which operated to international standards. Given the large costs involved in tendering in terms of the management time that had to be diverted to it, and the limited differentiation offered by the firms, a full tender did not look worthwhile at the time.

3. Discussions about the timing of the next tender were up to the Audit Committee Chairman (ACC) and were likely at the next Audit Committee (AC) meeting. The CFO wanted to remove himself from the discussion of this issue.

4. The costs to management of holding a tender would depend on what the firms wanted. But if the tender was properly conducted the three firms would have to speak to a lot of people around the world: probably some 30 members of the management team, drawn from finance, commercial and IT.

5. The company, in assessing the bidding firms, must be confident that they had fully understood what they were taking on. Otherwise the fee or the scope of their work could be understated. This applied particularly to the firms' ability to audit the overseas subsidiaries. While the quality of its overseas partners might be patchy, the firm needed to convince the company that it could drive quality assurance from the centre. If the company were to be dissatisfied with the work of an overseas partner, it would ask for that partner to be rotated [✂].

Switching

6. The CFO commented that the value of having the fresh pair of eyes of new auditors was offset by the auditors' initial lack of understanding and lack of experience of what

they were auditing. In the CFO's view, this lack of understanding meant that the new team was likely to miss something; and the lack of experience handicapped them when it came to making the many judgements involved in auditing. Sector experience helped to some extent with this but the first year of a new audit team's incumbency was difficult and involved a great deal of staff time in explaining the company's operations and systems. Risks were increased for companies with complex revenue streams; international spread; and/or a large number of statutory entities. Firms could mitigate the risks to some extent through use of technical departments and experienced audit partners, but the risks were still high. This was not the case when an audit partner was rotated because the audit team remained in place.

7. The benefit from switching was largely perception. This would be further improved by putting the AC in control of the process.

Frequency of tendering

8. The CFO considered that the FRC codification of a ten-year period between tenders was right. Companies would tend to arrange tenders to coincide with the rotation of an Audit Engagement Partner (AEP), and a ten-year retendering of the audit firm would be likely to happen as a matter of course.

Strengthened accountability of the external auditor to the Audit Committee

9. The CFO said that putting the negotiation of the auditor's fees wholly in the hands of the ACC was an interesting direction to take. He could see some benefits in it, even if it took one element of finance out of the CFO's control. It would demonstrate that the AC was fully in the lead in running the relationship with the auditors, and would sit well with the requirement for the AC to set out its policy on auditor tendering and rotation.

Enhanced shareholder–auditor engagement

10. A direct line between investors and the AC was desirable (and already existed in some companies), but the CFO was not sure how a more formal relationship would work in practice. Institutional investors tended to want to go their own way and already had a direct line to the AC on matters in the annual report if they wished to do so. Investors were a dispersed group.

Market developments

11. The CFO expressed concerns that market developments were increasing the risk that one of the Big 4 firms would leave the market. Moreover, these firms were re-designing their business models and this could result in firms splitting their audit work from their consultancy businesses. Audit-only firms would not attract the best graduates and the quality of auditing would consequently suffer. The second-tier firms could not take on the complex, international accounts of companies like Company O. It was unclear what was causing this trend but it could be related to the marginal profits of conducting audits compared with the richer profits of consultancy. This could be compounded by the rising costs of tendering at a time when, with tendering becoming more frequent, the chances of retaining engagements were diminishing.

Views of the Audit Committee Chairman

12. The ACC confirmed that one of the Big 4 audit firms ([✂]) had audited the company for many years [✂]. However, the company held a 'soft' tender a few years ago [✂] as part of a review, at the instigation of a new CFO, of all the company's major external relationships. The CFO initially made contact with two other Big 4 firms before consulting the ACC. The ACC and CFO conducted separate discussions with the two other firms so as to test the market, but this had fallen far short of a full tender. This exercise had not been driven by any concern about the existing auditor or by any event. The ACC and CFO had not gone on to propose a full tender because the prospective benefits did not appear to outweigh the costs and there was a heavy workload at that time across the whole Group. The company did not tell its incumbent that it had been in contact with the other firms and did not use the information to leverage any change in price or service from the incumbent.

13. Company O's ACC had been engaged in a full tender for both an internal and external auditor as ACC at a not-for-profit organization ([✂]), had also been ACC at other listed companies ([✂]) and had experience of changing auditors when companies had been acquired (some of which were listed), leading to the appointment of the group auditor to audit the new subsidiary.

14. The ACC believed that there was not a fundamental difference in the nature of the role as ACC at Company O compared with other companies.

Tendering by Company O

15. The ACC said that the AEP had rotated at the company's last AGM. [✂] A transition process for the new AEP had been started some months ago and was overall not disruptive for the company.

16. In line with the statement in the AC report that it would consider the timing of the next formal tender, the ACC confirmed that this would be on the agenda of the next AC meeting. The ACC said that the AC regularly debated the quality of the audit and this sometimes led to discussion of the possibility of retendering, but this would be the first AC meeting at which the latter was a dedicated agenda item. This reflected the wider consideration of the issue by the CC and others.

17. The ACC expected that the AC would take a decision on the timing of a tender. A ten-year cycle was then likely to be introduced, as a backstop arrangement, from the date of the next tender.

18. The ACC considered that there were benefits to be gained from a cycle for tendering; the key question was when to establish that cycle. Ten years seemed a reasonable period for the cycle (five years was too short). But changing auditors after this period should not be mandatory—although it had to be believed that this was a real prospect if the tender process was to be meaningful. Ultimately it was right that the shareholders had the final say.

19. The ACC thought that the 'comply or explain approach' was appropriate; every company with which the ACC had worked had been fully committed to compliance.

20. Mandating more frequent tendering and switching could, in the ACC's view, reduce the numbers among the Big 4 firms ready to bid for particular tenders; if they considered that they would end up winning only a few audit tenders, they might weigh up the cost of losing the non-audit services they were providing to a company against

the prospects of being awarded the audit and decide not to bid for the audit tender, reducing the Big 4 firm pool in those cases to one or two firms.

Experience of tendering/switching

21. The tenders at the not-for-profit organization (see paragraph 13 above) had been held because the organization had not considered that it was receiving an adequate level of service from the incumbent auditors, and a decision was taken to test the market. The ACC described the tender process as an 'onerous task' because every part of the process had to be determined after lengthy internal debate [✂].

22. This tender had resulted in a switch of auditor to a Big 4 firm; the 'fresh pair of eyes' had been beneficial and there had been a step-change in the handling of the organization's audits. However, it had not previously been getting the right level of service.

23. The ACC had also considerable experience of appointing the firm acting as group auditors of companies as the auditors of newly-acquired companies. The ACC said that the Big 4 firms were skilled in this process and having one auditor for the Group provided better assurance and was cost effective, as the incumbent auditor knew the acquiring company's policies, procedures and standards and could consequently provide a consistent audit and add value to its reports.

Costs of tendering

24. The ACC thought there was a danger that companies might be required to issue tenders too frequently. It was expensive for the bidders to respond to tenders and the costs would be passed on to the audit firms' existing clients. The AC at Company O had not, as far as could be recalled, discussed the costs and benefits of tendering but there was clearly a high cost to companies if the job was done properly. It was necessary to ensure that bidders had the same knowledge of the company as the incumbent and the briefing of potential bidders was onerous.

25. The ACC believed that it was definitely beneficial to go out to tender if a company was not receiving the right level of service, and was a good way to test the market. However, the ACC could not say that tendering would always benefit a FTSE 100 company.

26. The key ingredient of success for an auditor of a multinational company was getting the local delivery right. Much of an audit firm's work was performed abroad and the strength of its local offices was a major consideration. In reaching a decision on the appointment of an audit firm, an assessment of the bidders' capabilities overseas was therefore extremely important. Company O made a point of writing to the financial officers in its overseas operations for assessments of the local representatives of audit firms, and the ACC believed that was the practice of most multinational companies.

27. The ACC commented that the five-year AEP rotation cycle went very quickly and felt that holding a tender every five years would be too frequent. The ACC believed that the cycle of tendering needed to be sufficiently long as it was more likely that a tender would lead to a change in auditor; if tenders were too frequent, there would be greater inclination to reappoint the same firm for another short cycle. The ACC concluded that ultimately it should be the shareholders' decision on which firm should audit a company.

Other remedy options

28. On the possibility of enhancing shareholder–auditor engagement, the ACC could recall few occasions when he had spoken to shareholders in the capacity of ACC. On one occasion, a large investor who had set up a governance function [✂] had requested a meeting with the ACC but the audit had not been mentioned. On other occasions, the ACC had attended meetings organized by legal firms and other organizations to discuss topical issues at which investors and non-executive directors had been interspersed.

29. The ACC concluded that if a company had the right people, with the relevant knowledge and networks, as non-executive directors, the AC would be able to make rational decisions on the processes for retendering and make sound assessments on the quality of a bidding audit firm.

30. The ACC did not think that providing additional information to major investors would lead to any more effort in reviewing the financial statements.

31. Reading audit quality and review reports had confirmed the ACC's views on the relative quality of firms.

32. The ACC noted that there was no disclosure on the level of non-audit services provided by audit firms other than the auditor and such disclosure might place the auditor's non-audit services in a different perspective.