

## STATUTORY AUDIT SERVICES

### Summary of calls held with Company N

#### CC note

See [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/case\\_study\\_cover\\_note.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/case_study_cover_note.pdf).

Company N is an asset management company. It employs over 3,000 people in over 20 countries around the world.

Having never done so in the past, Company N put its external audit out to tender recently.

#### Views of the Chief Financial Officer

1. The Chief Financial Officer (CFO) explained that, before the tender for the audit was held, the incumbent audit firm had been subject to the company's annual assessment process involving all operational and executive management who had dealt with it, as well as the Audit Committee (AC) and Chairman of the company. The decision to hold a tender was driven by a departing Audit Committee Chairman (ACC) [redacted], who favoured tendering in principle, and an incoming ACC [redacted] who was keen to respond to market developments, and test the market. In addition, the company anticipated that changes to the FRC's Corporate Governance Code would be made.
2. There had been no concern about the performance or the fees of the incumbent auditor in advance of the tender. The firm ([redacted]) scored highly and cost was less important to the company than service quality.
3. Although there had been discussion of the strategic timing to go out to tender in anticipation of changes in the Corporate Governance Code (and a potential surge in tendering), this did not form part of the decision to hold the tender when the company did.

#### *The tender process*

4. The process of identifying possible other suitable audit firms was initiated by management in the summer of [redacted] with a request to the Big 4 and three other firms for information about the range of professional services they could provide, to allow the company to use a wide range of suppliers to ensure that it was not artificially constrained in its choice of auditor should it decide to switch.
5. Management had envisaged that a tender would only be held the following year but the AC pressed to run the full tender in [redacted]. This was therefore started on [redacted] with an invitation to tender going to the Big 4 firms. It had been determined that only the Big 4 firms could handle the complexity and global reach of the company's activities; in the CFO's view, the smaller firms would not want to bid for the full audit but would be considered for other non-audit service contracts. Tendering for non-audit services (NAS) continued on an ad-hoc basis; it was significant because by having identified other firms with the competence to provide these services freed the main auditor from potential independence issues.

6. The tender process gave the bidding firms extensive access to non-executive directors and financial and non-financial management worldwide. In each interaction, the firms were awarded scores and given rankings. In scoring the firms, the company applied four main criteria: (a) oversight and governance (eg safeguards for independence, communication); (b) planning and delivery; (c) people and succession planning (eg their judgement, technical abilities); and (d) value. The meetings lasted about an hour to an hour and a half, with the firms having to provide agendas and CVs in advance, and involved at least 30 meetings with the company's staff.
7. Data rooms were set up, subject to legal and confidentiality safeguards. The CFO acknowledged that the in-house legal team had concerns around sharing some company information (eg on litigation issues) but he made a judgement to disclose, because he considered that this allowed him to test the firms' diligence and comprehension of the information effectively. The CFO believed that having a data room enabled firms to understand the company and its processes more fully before they met with staff. This proved a useful exercise, not only showing how diligent and perceptive the candidate firms were but also reducing significant business disruption.
8. The firms were then asked for written statements, which were read by all ACC members, the CFO and other relevant management executives and scored. A number of questions to be put to the candidate firms during their presentations were identified by the company, to either clarify or challenge aspects of the written proposal.
9. Finally, the firms made oral presentations to the ACC, with executive management (including CFO, Group Financial Controller and General Counsel) and the Chairman present. No firm had been eliminated up to this stage but two front-runners rapidly emerged.

### ***Choice of auditor***

10. Considerable debate ensued on issues such as the two firms' knowledge of the financial sector, experience in auditing international FTSE 100 companies, expertise on regulation around the world, the personalities and styles of those who would be involved, and ability to reach sound audit judgements. The CFO identified the prospective Audit Engagement Partner (AEP) to be a key factor in making the decision and believed that the winning firm ([REDACTED]) prevailed because of the quality of the people in its audit team. The fee was not an issue; the winning firm was more expensive than the incumbent firm, which had kept the proposed fee to its pre-tender level.
11. [REDACTED]
12. [REDACTED]
13. [REDACTED]

### ***Resource implications***

14. The CFO said that the cost to bidding firms was enormous. For the company, it amounted to some £[REDACTED] relating to delays incurred in major IT projects (including a new billing system and financial reporting system) that were under way at the time, plus the opportunity cost of taking employees off other work. For the CFO, the tender would have involved some three to four weeks over four/five months, but this represented extra work, whereas two individuals reporting to the CFO were working

almost full-time on the tender, significantly displacing other work. However, the tender coincided with other important changes within the company, and the resource cost was likely to be lower if another tender was held in different circumstances. The CFO said that there would be no need to organize any future tender in a radically different way.

### ***Mandatory tendering and rotation***

15. The CFO acknowledged that some companies might want to be seen to take the initiative in changing auditors and that some shareholders favoured rotating audit firms. However, this was a two-edged sword: the benefits of casting a 'fresh pair of eyes' over a company's business had to be set against a deterioration in the quality of the audit in the initial years.
16. The CFO had reservations about the possible remedy of mandatory rotation of audit firms because this would reduce the company's choice from four to three firms. Mandatory tendering would be preferable to mandatory rotation. However, the CFO considered that the timing of tenders should be left to the discretion of the companies, although it might be desirable to identify a trigger event to determine when a tender would be required.
17. The CFO considered that the 'comply or explain' rule was reasonable. ACs needed to explain their intentions. While clearly an implicit encouragement to compliance, there was likely in practice to be a range of responses from companies.

### ***Other possible remedies***

18. The CFO had referred to audit quality and review reports in the past, and considered that audit quality in the FTSE 350 and particularly in the FTSE 100 was very high. Generally, the CFO was sceptical that greater scrutiny of auditors was necessary; the quality of audits was high in FTSE 100 and many other listed companies, and the existence of the process was sufficient incentive.
19. He supported the removal of the 'Big 4 only' clause in loan documentation; the audit should be open to any firm qualified to undertake it.
20. The CFO did not see that the audit firms had misaligned incentives as between shareholders and company management. Auditors had three lines of communication into companies: first, to the ACC (whose interest was in ensuring that the numbers were fairly presented); second, to shareholders (a legal responsibility, but with little content in the relationship or a desire for any direct relationship); and third, to management (whose interest lay in getting the best value for money). The CFO thought that any extended reporting requirements should be included in management reports, such as the Audit Committee Report, and that further efforts to constrain auditors' ability to undertake NAS were unnecessary, given the existing large volume of ethical guidance. He saw little scope for further restrictions.

### **Views of the Audit Committee Chairman**

21. On joining Company N as a non-executive director [X], the Audit Committee Chairman (ACC) had been surprised to learn that the company had never held a tender for an audit engagement. The ACC questioned how a company could know what the market had to offer without a tender. The ACC stated that without a tender, a company did not have enough information to know if it was getting the best or to assess if the service it was receiving was sufficient. However, the ACC did not push

the company on this issue, gradually coming to realize the costs and the major exercise that would be involved. Nonetheless the ACC still inclined to the view that the company did not have enough information about what was available in the audit market.

22. When it became clear that support for mandatory tendering was growing among regulatory and professional bodies, the CFO proposed, and the ACC agreed, an exercise to gather information about all the services that audit firms were able and willing to provide Company N, with a view to tendering for some of these services in the following year. However, as the exercise progressed, the ACC and others came to the conclusion that the key service was the external audit and it was crucial to get this right; the provision of NAS could follow from this. The exercise was therefore transformed into a full tender.
23. The ACC thought that the company's management would probably have chosen a different time and would have followed the original planned timetable. There was a lot going on in the company at that time, but that would probably always be the case. [REDACTED]
24. There was also a strategic element in going out to tender at that time. With many other tenders by different companies likely to be held, but with uncertainty over when and in what order, there was an advantage in being 'ahead of the game' so as to get the best terms and teams on offer. One of the worries about regular tendering for audit services, in the view of the ACC, was that audit firms would not be able to put the same level of cost and commitment into every bid, and some companies would not get the best offers. There was a balance to be struck between the frequency of tendering and the value of the offer. (In Company N's case, it was intrinsically desirable to tender when it had never tendered in the past but it did not follow that it should do so every five or ten years.) (See also paragraph 33 below.)
25. The ACC played an important role in assuring prospective bidders that the tender process was going to be fair and open; the company was equally open to a change in auditors or to reappointment of the incumbent. There was otherwise a danger that the inclusion of the incumbent in the invitation to tender might have reduced the efforts of other bidders.

### ***The tender***

26. The ACC had not asked for a costing in advance of the tender but appreciated that the cost would be substantial if the tender was to be conducted thoroughly and properly, which the ACC knew the company would do.
27. The ACC reckoned to have devoted about ten days, in addition to normal activities, to work connected with the tender. More of the ACC's time had been spent in the design of the tender process and establishment of the evaluation criteria than in interviewing and evaluating the four bidding firms.
28. The conduct of the tender had involved some disruption for the company between [REDACTED] and [REDACTED], particularly for the financial functions and for some service staff. For example, competent note-takers had to be found from among the staff to provide records in a consistent way of the 28 interviews with each of the four bidding firms. Consistency of the notes was important to help make the scorings against evaluation criteria. These meetings were used to allow the firms to collect information to produce their tenders, but company staff were also requested to provide feedback to the team running the tender to assess the firms' understanding of the company and the relevance and level of detail of questioning.

29. The level of proposed fees had not been a significant factor in assessing the bidders, but the ACC had expected that the competition would sharpen the bidders' offers.
30. [X]
31. [X]

### ***Switching: the key criteria, costs and risks***

32. The ACC was more concerned about the risks of switching than the costs. The biggest risk was that an incoming firm would not know as much about a company as its predecessor and would be less prone to probing questioning. The value added of having a 'fresh pair of eyes' to undertake an audit had to be weighed against the costs and risks. In the case of Company N's tender, the former just outweighed the latter, although extremely marginally.
33. For the ACC, the key factor in an audit engagement was the quality of the AEP, particularly the AEP's readiness to engage in dialogue with the AC and the degree of scepticism applied in his or her approach. The audit firm from which the AEP came was of lesser concern. There was little difference between the Big 4 firms; audit services were almost a commodity product. The quality of a prospective AEP could be assessed during interviews as part of the tender process, on the basis not only of what was said but what was not said, body language and so forth. It was therefore important for a company to get to know the audit team during a tender process.
34. Some thought had been given to reducing switching costs. Careful transition planning was considered as one way of doing so and formed part of the firms' proposals. The ACC said that no discounts had been offered by the firms to compensate the company for the switching costs. [X]

### ***Continuing role of an ACC***

35. The AC had total influence on the annual reappointment of the external auditor. Being the body that decided whether or not to issue a tender, the AC should routinely bear in mind the option of a tender and whether any of the other firms providing NAS might be able to undertake the audit. In Company N's case, each year an assessment of auditor performance was conducted, drawing on input from management and the AC. Management also annually prepared a substantial paper addressing whether to recommend reappointment of the auditor which included consideration of any potential performance issues. In this paper, management also offered summary views on the other possible audit firms, based on the NAS they had performed.
36. The ACC did not get involved in the annual fee negotiations with the auditor, except to provide oversight. Rather than putting on any pressure for a lower fee, the ACC was more concerned that the fee was sufficiently large to ensure that the auditor's job was properly done, and sometimes spoke to the AEP about this. The ACC assessed the proposed fee by considering the year-on-year change, but did not refer to other companies' audit fees as a benchmark.

### ***Mandatory tendering and switching***

37. The ACC considered that a remedy of mandatory tendering, especially in combination with mandatory rotation of audit firms, represented a large risk. In the ACC's view, the more frequent the tender, the less the potential 'prize' to the audit firm and the higher the cost and risk relative to the perceived benefit for both company and

audit firm. As a means of reducing these costs, there was a risk that the running of a tender could become purely ritualistic, with no change in auditor at the end of the process. The combination of mandatory tendering with mandatory rotation every second tender, say, could lead to a situation in which only a ritual tender was held at the intervening period. The ACC nonetheless favoured regular market testing.

38. The exclusion of the incumbent firm would reduce competition and for a global company, with the stringent independence rules, this could lead to a further reduction in qualified bidders. [✂]
39. The ACC did not perceive there to be significant efficiencies from more frequent tendering, given the extensive range of interviews needed to be held to allow firms to tailor their tenders. There would potentially be an increase in the level of ongoing monitoring or shadowing of the company by firms, particularly as a tender was anticipated to be held, to improve firms' understanding of the company's business, but overall the ACC did not think this would reduce costs.

### ***Other remedies***

40. The ACC's views on other remedies in the Notice were:
  - Expanded remit and/or frequency of Audit Quality Review team (AQRT) reviews: the AC had considered the AQRT report on the company at the time, within the annual assessment of the incumbent. Company N also used the public AQRT reports on each bidder within the audit tender. The frequency of reporting could possibly be linked to the incumbent auditor's length of tenure. This could provide an AC with an independent check on audit quality.
  - Prohibition of 'Big 4 only' clauses in loan documentation: in full agreement on this proposal.
  - Strengthened accountability of the external auditor to the Audit Committee: there was a danger this could lead to the AC taking on undesirable 'hands-on' executive functions, such as fees negotiations. The key to such accountability was the relationship of the AEP and the AC.
  - Enhanced shareholder–auditor engagement: the key here too was the AEP relationship with the AC, which, together with the other non-executive directors, represented all shareholders; the ACC was unimpressed by a suggestion that shareholders might be given a choice at AGMs between two possible auditors; the non-executive directors represented all shareholders and would have been through the process of evaluation so as to make a informed recommendation to shareholders.
  - Extended reporting requirements: the ACC saw no benefit in requiring more reporting by companies but saw some merit in extended reporting by audit firms.