COMPETITION COMMISSION

STATUTORY AUDIT SERVICES

Summary of calls held with Company P

CC note

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

Company P was listed on the LSE in [✂] and is now in the FTSE 250.

One of the Big 4 audit firms, [✂], had been the company's auditor for nearly 20 years. In 2011 the company switched its auditor from one Big 4 firm to another, namely from [✂] to [✂].

Views of the Group Finance Director

Tendering

1. The company recently created a global procurement function to review its supplier relations. The audit tender was triggered as a result of this review. Relevant to the decision to go to tender was the fact the incumbent had been in place for nearly 20 years and because the audit partner was due to rotate, which would have resulted in some loss of continuity. The Group Finance Director (GFD) said that fundamentally, he saw the audit service as being for the benefit of shareholders.

2. The key objectives of going to tender were: *(a)* to ensure that the company was obtaining a cost-effective review that met the needs of the Audit Committee (AC) on shareholders' behalf; *(b)* to look at the audit approach, including using the company's internal audit function to a degree that avoided duplication of effort; and *(c)* to check the cost of the audit against market rates (the company's audit fee had incrementally increased each year).

3. The company invited the Big 4 firms to tender because each had an existing relationship with the company. The GFD said that any of the Big 4 firms was capable of completing the audit, but the selection decision was made on the basis of cost, the perceived effectiveness of the auditor; and the company's view of the individuals put forward from each firm. The GFD said that it was important for the company to have a good working relationship with its auditor and, in particular, the individual members of staff.

4. The tender process took three months to complete. The process was structured as follows:

   (a) The AC and [✂] divisional Finance Directors (FDs) were consulted to discuss aspects of the audit service that had gone well and those that could potentially be improved.

   (b) A short-list of four firms was agreed and calls held with these firms to establish interest and confidentiality agreements sought.

   (c) An invitation to tender was sent out to all four firms, together with a briefing pack.

(d) Each bidder held seven 1-hour meetings with the company, which included a separate meeting with the Audit Committee Chair (ACC), Chief Executive Officer (CEO), GFD, Group Financial Controller (GFC), Head of Internal Audit (HIA), and two divisional Finance Directors. This was carried out over a three-week period.

(e) Following the submission of written proposals, each bidder was invited to make its case for appointment in a presentation. All four firms were seen on the same day in individual meetings led by the ACC and involving the CEO, GFD, GFC and HIA.

(f) A recommendation to appoint one of the firms was then made to the AC, who met and approved the decision. The FD then conducted subsequent negotiations to finalize the scope and fee of the engagement.

5. The tender was launched in the first half of the year to ensure that the newly-appointed auditor would be in place to conduct the half-year audit review. The GFD said that the opportunity to conduct the less burdensome half-year audit review was important to ensure that the newly-appointed auditor would be up to speed for the end of year audit.

6. The company entered into a three-year fixed price agreement with the newly-appointed auditor, that could be adjusted for changes in scope.

7. The GFD said that going to tender every seven to ten years would obtain the best price and service. He noted that the term of office for non-executive directors (NEDs) was six to nine years. The GFD would not want to go to tender more frequently than a six-year period because this would send a negative message to shareholders about the company's relationship with its auditor. The GFD said that the mandatory rotation of audit engagement partners every five years provided a sufficient safe-guard to ensure that a fresh pair of eyes was involved in the audit.

8. The tender resulted in a 50 per cent reduction in fees, from £[✂] to £[✂], and remained at this level the following year. The GFD said that going to tender would almost always reduce the fee. The incumbent had initially offered a fee reduction prior to tender of £[✂] and had offered the lowest fee in its tender. The GFD said that, despite this, the company was less likely to appoint the incumbent auditor given that it had gone out to tender. He thought the incumbent's odds of success were lower than other bidders (all else being equal) because of this.

9. The GFD said that auditing was a relatively commoditized service and each of the Big 4 firms was capable of offering a high level of service in the company's geog-raphies. The ACC said that there was intense price competition at the tender.

10. The successful auditor was appointed because its proposal focused on delivering a high-quality audit and had stated that it would not look to offer additional services. The GFD said that the successful auditor was also well structured to meet its group needs in relation to its overseas audit requirements.

11. The GFD said that the tender process did not cause a big disruption for the finance team and any disruption which did occur was at the beginning of the new auditor's appointment, when the new auditor needed to get up to speed. In terms of manage-ment time, he thought the process had required three weeks of combined GFC and HIA time, two weeks of his time and one week of each of the CEO and ACC's time. He estimated the cost of this time to be approximately £100,000 to £150,000. The GFD noted, however, that this time was spread over three months and was absorbed into the individuals' existing workloads and did not represent a cash cost.

Switching

12. The GFD said that both the company and the new audit firm were very conscious of the potential risks involved in switching auditor, and as a result the new auditor spent significantly more time on the interim audit review conducted at the half year, in order to reduce the risk of problems at the year end. The disruption caused by the switch was felt mainly at the interim audit review. The new audit team spent significantly more time on the interim audit (perhaps [six times as much]). The company spent more time with the auditor—perhaps 60 man-days at a cost of £50,000 to £60,000.

13. The GFD said that the scope of the audit was the same, but the extra time was necessary at the half year to enable the newly-appointed auditor to understand the company's business.

14. The GFD said that the planning cycle for the year-end audit was slightly more intense and that the new audit team went into more detail in some areas during the year-end audit; but the extra time commitment was less noticeable than at the half year.

15. In the GFD's opinion, the new auditor was up to speed within the first year and the costs of the tender and the switch did not outweigh the benefits.

Views of the Audit Committee Chair

Tendering

16. The events leading up to the tender process built up over a couple of years. The company received a satisfactory audit, but it was unhappy with aspects of the partner's style, the audit team's composition and interaction with the company. The ACC thought that this was not unmanageable but it was not at the level he expected it to be. These issues were largely resolved with the introduction of a new partner to the team. However, when this partner left the audit firm after two years this served as the trigger to launch a tender.

17. The ACC said that with a new CEO taking a fresh look at the company's relationships, and a desire to test the audit market again having worked with other firms in a non-audit context, the idea of a tender was already being discussed. The prospect of going through another transition process (only two years after a change of partner) acted as the catalyst to initiate the tender. The decision to tender was a collective one taken by the ACC, CEO, CFO and Financial Controller. The ACC stated that price was not priority number one but there was an expectation that the fee might be reduced.

18. The company invited each of the Big 4 firms to tender as the company had worked with each firm on other bits of work. Each firm spent time with the FD, Financial Controller and CEO to gain context of the company. The ACC agreed how the tender would be run in advance of the process, and during the tender itself he had one meeting with each firm during its 'preparation' stage, and attended the final presentations and subsequent selection meetings.

19. The ACC estimated his time commitment to be approximately 15 hours, equating to a couple of extra days' work. He spent 15 to 20 days per year working on business related to the company, roughly half of which was related to his role as ACC. He thought the amount of extra work required of him and the company during the tender was not sufficiently material to affect the decision to tender. The ACC estimated that there were perhaps four 1-hour long meetings for each firm with different members of executive management in addition to the firms meeting with more junior staff.

20. The ACC thought the company conducted a very good process which had been thorough and fair. The incumbent auditor came to the tender with a new team and an entirely fresh approach with more involvement from senior staff, such that if the incumbent had been reappointed the tender would still have been a worthwhile process.

21. The ACC thought that if things were working well with the incumbent auditor, tendering was not top of the agenda. He thought that the ten-year 'comply or explain' rule (recently introduced by the FRC) was satisfactory for the company.

22. The ACC compared his experience at the company with another company where he was CFO ([✂]). This company had used the same auditor ([✂]) since an Initial Public Offering (IPO) in [✂], but there was no compelling reason to change auditor. If anything, the quality of the team had improved over time. The ACC at this company was not afraid to test and challenge advisers—other advisers had changed, but the ACC thought it received a very efficient audit and was appropriately priced.

23. He thought that the auditor had deep knowledge of the industry, and that the company had the best partner for the job working on the audit. There were also excellent controls around partner succession and good continuity. The ACC thought it was valuable to have people, such as the auditors, to use as a constructive sounding board. The ACC had had 'thousands' of investor meetings in his role as CFO at this company and there was no mention of the auditor.

Switching

24. The ACC had an expectation that there would be costs associated with switching auditor, but this was not a significant concern. He had expected the fee to be less as a result of the tender, and that the saving the company achieved outweighed the cost of running the tender.

25. The main impact on costs was in the first year after a switch. The ACC estimated that the education and transition of the new auditor required approximately '30 per cent more effort' from the auditor and from those in the company directly involved with the audit. He thought the transition had been handled well—there were standard introductory documents prepared for the auditors and a well-defined series of meetings with relevant members of staff. The biggest impact was in the first year after a switch and it probably took two year-end audits for the auditor to be totally up to speed.

26. The ACC had no concerns of audit failure following the switch as he was confident in the internal controls and team at the company, and all the Big 4 firms had done work for the company so the new auditor was not starting from scratch.

27. The ACC stated that to conduct a proper tender process it would be beneficial for it to be done at a time that suited the company—it had to fit in to the corporate calendar as it was less costly and disruptive than if other things were going on.

28. The transition process was smooth, which the ACC expected, and the process did not really incur extra AC time—it was similar to the relationship with the previous auditor. The most detailed briefing was from the Financial Controller, who spent perhaps ten days of time on it. The ACC did not notice any delay or disruption, but acknowledged that people were putting in extra time to achieve this that he did not observe.

Remedies

29. The ACC did not see the benefit of mandatory tendering—he thought that the current corporate governance regime was sufficient, and thought it unlikely that many companies would choose to ‘explain’. He thought that a ten-year period was sensible to ensure some movement. He thought that mandatory rotation was not necessary, and that removing choice (as entailed by mandatory rotation) could have adverse consequences.

30. He thought that Audit Quality and Review reports were useful, and increasing the frequency of their reports to every five years would be beneficial.

31. He supported prohibiting Big-4-only clauses in loan documentation—he thought it unlikely that this change alone would have a significant impact but it was a sensible thing to do.

32. He did not see any advantage of strengthened accountability of the auditor to the AC—the auditor would need to be closer to management to understand the details. He was not in favour of NEDs getting involved in more executive operational matters. Taking the example of audit fees, the ACC had a good sense of value, but would not want to be involved in negotiating the detail.

33. The ACC thought the concept of enhanced shareholder–auditor engagement was a good one, but care was needed over the structure—he had experienced ‘clamour’ about the audit and things tended to happen only when there were issues at a company. If a company was in good shape, then this was unlikely to make a difference, but if there were issues facing a company then more interaction was a good thing.