COMPETITION COMMISSION

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of calls held with Company U

CC note

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

Company U is listed on the London Stock Exchange. It has grown through acquisitions over recent years. Following the acquisition of a company, which resulted in existing auditor appointments being spread between member firms from a number of international networks, the Audit Committee (AC) decided to conduct a competitive selection process between the incumbent ([✂]) and two other firms. [✂] was appointed.

Views of the Group Finance Director

Tendering

1. The Group Finance Director (GFD) said that the tender for a new auditor had been initiated following reviews of the incumbent's performance and the acquisition. The company needed to ensure that the audit gave full coverage of the business across different parts of the world and there had been some concern (with which the AC agreed) about the performance of the incumbent in some respects. [✂] Although these concerns had been discussed with the incumbent at annual reviews, the decision was taken to test the market.

2. The GFD said that a key consideration was the ability of the audit firm to audit all of the subsidiary companies worldwide. Appointing different auditors for the different geographical segments of the business was not seriously considered; a single firm would be more efficient managerially, would drive down costs, would (he supposed) be able to take assurance more readily from other member firms in the network, would find it easy to co-mingle audit teams and would be able to ensure compliance.

3. The conversation about whether to hold a tender was held with the Chairman, CEO, GFD and other members of the executive management team. Management then spoke to the AC about their views and the AC made the formal decision to run a tender process.

4. The tender was initiated by a letter to three audit firms with which the company had pre-existing relationships ([✂]), detailing how the company would like them to approach the tender. The firms were given access to question about ten members of the senior management team throughout the Group. Closing meetings at that stage were held between the GFD and each firm. The three bidders then submitted documents, in which analysis of the risks of the business was an important area of coverage, before making a presentation to the panel comprising the AC and executive management representatives.

5. To assist the assessment process, the bidders were scored against a list of attributes and the scores were then added up on a weighted basis. Key attributes scored were competence, challenge, and strong leadership. It proved a successful process, but involved expenditure of time by the GFD (around 20 hours during the tender process

itself spent on meetings, reviewing proposals and attending presentations) and others. The cost was essentially an opportunity cost of management time.

6. [✂]

7. In general, the GFD thought that the cost-benefit analysis for going to tender might not stack up if a company was content with the audit firm. He believed that tendering at least every ten years was likely to be reasonable and supported the existing ten year ‘comply or explain’ policy. The cost of tendering was high, but even if a company was satisfied with its auditor, it was not possible to test the market without going to tender.

Switching costs

8. Commenting on the disruption within a company after the appointment of a new auditor, the GFD said it arose from the auditor’s need to acquire a greater knowledge of a company, including of its control systems, the direction it was moving, and the attitudes of its people. This effect was felt for the first year or two. In subsequent years, the audit firm would be expected to make efficiency improvements but as time went on would face different challenges in response to changes within the company.

9. One risk involved in appointing a new auditor was that the incoming firm would go through the accounting policies in some detail and might disagree with its predecessor and this presented a degree of risk. This risk could be seen as a benefit in terms of getting a ‘nuts and bolts’ re-examination without making a restatement as a result.

10. The switch had not resulted in any fee savings. The differences between the fees quoted by each bidder had been modest ([✂]) and the level of the fee had not been a priority for Company U in choosing a new auditor. [✂]

Other possible remedies

11. The GFD commented on the remedies set out in the Notice of possible remedies as follows:

    (a) *Mandatory tendering*: ‘a sledgehammer to crack a nut’. Companies and ACs were capable of making judgements on the timing of tenders. They were not seeking a soft audit but rather wanted a vigorous approach from their auditors. Change for change’s sake was not a good use of a company’s resources. The GFO believed that a company’s response to the need to comply or explain ‘tells something about management’ to shareholders.

    (b) *Mandatory rotation of audit firm*: response as at *(a)* above. This would be a step too far for a company that was receiving good value from its auditors.

    (c) *Expanded remit and/or frequency of Audit Quality Review team (AQRT) reviews*. Any improvement in this area would help companies; it would be an audit of the auditors. However, an audit was, by law, conducted for the benefit of the shareholders and there was a danger that expanded AQRTs would not be designed to address the right stakeholders, ie the shareholders. The GFO questioned how this measure could address competition, as opposed to audit quality. The GFD had seen AQR reviews previously and believed the firms took them very seriously. He considered that they had a positive effect on audit quality.

(d) *Prohibition of 'Big 4 only' clauses in loan documentation*. The GFD could not understand how such clauses could be allowed.

(e) *Strengthened accountability of the external auditor to the AC*. The level of accountability was strong already.

(f) *Enhanced shareholder-auditor engagement*. The GFD said that institutional shareholders did not turn up at AGMs and he had never been asked a question by a shareholder about the audit.

(g) *Extended reporting requirements*: a sensible and robust framework already existed for disclosure and any changes should be taken forward within that framework. The GFD questioned that having another report by the auditor would enhance competition. The cost of compliance would grow steadily, strengthening the Big 4 audit firms and hindering competition. It was the companies, not the audit firms, that should make all disclosures

Views of the ACC

Tendering

12. The ACC, [✂], explained that there had been several considerations leading up to the decision to organize a tender some [✂] years ago. The incumbent auditors had been in place for a decade and a tender was seen as good corporate practice. The company was not convinced that the Audit Engagement Partner (AEP) was giving sufficient time to the company, largely because of other commitments. The company was looking for a more challenging audit than was being provided and had noted that issues the CFO and ACC had expected (or been led by staff feedback to expect) to come up had not been raised during the audit. Moreover, the incumbent was not considered to be strong in the [✂] sector in the geographical areas in which the company had set up new operations [✂] Nonetheless, despite this accumulation of factors, the company's mind was open to reappointment of the incumbent.

13. The decision to go out to tender was not taken lightly and without the concerns about quality the drive to go to tender would have been lower.

14. The suggestion of tendering the audit had been initially raised by the CEO and the CFO but was welcomed by the AC members, who shared their concerns.

15. Three of the Big 4 firms were invited to tender. The selected firms (and in two cases the prospective AEPs) had relationships with Company U, and the fourth firm, unlike the other three, had not made any approach to the company. The company also had concerns about the amount of management time that would have to be spent on servicing and assessing four bids at a particularly inconvenient time for the company. The ACC considered that a competition among three firms gave the company sufficient choice but that was the lowest number of firms it would wish to consider. In other circumstances, the number invited to tender might have been greater.

16. In arranging the tender, the company gave the bidding firms access to various senior people, including the ACC. The bidding firms produced a document to support their bids and made oral presentations. The ACC personally spent probably three days on the bids—three hours briefing each bidding team, time spent in discussions with the CFO and reviewing the written presentations, and a day attending the oral presentations and the subsequent internal discussions [✂]. Overall, the cost for a company in conducting a tender was the time that had to be devoted to it if all bidders were to be given a fair chance.

17. Presentations were also made to the local finance teams in the overseas locations [✂] and the feedback from these teams was taken into account by the selection panel.

18. A key criterion for selection was the ability of the AEP. The AEP needed to be able to communicate effectively (both in writing and orally) and in a positive way with both the ACC and the CFO and needed to have the expertise to deal with the markets concerned and with the countries in which the company operated. [✂]

19. All of the firms tendering had proposed a similar fee.

20. Ultimately the decision to appoint was made on the basis that the proposed AEP had come across as both knowledgeable and challenging both during the tender and in previous dealings with the company.

Switching costs

21. In the ACC's view, companies avoided holding more regular tenders for auditors because they valued having an auditor with a deep knowledge of the company concerned. The knowledge that an incumbent auditor had acquired was inevitably lost when the auditor was switched, and the incoming firm needed to make a heavy investment to acquire a comparable level of knowledge. The first year of a new audit was always the most difficult and carried risks that the auditors could miss an important issue. This put an important responsibility on an AC to make sure that all issues that should come up in the audit did so. It was therefore an advantage for the AC to have an auditor who fully understood the business.

22. The disruption to the company during the induction period of the incoming auditors was expected, and whilst any disruption might be perceived to be a cost, this scrutiny from a fresh pair of eyes was the benefit of switching. The ACC would have been worried if the new auditor had raised fewer questions and had not demanded a lot of attention from both senior and junior staff. The auditor had to build up a permanent file, and did so through obtaining explanations of financial controls and systems from finance staff. It was an investment the company was prepared to make. The company had monitored the time and resources the new auditors were putting into the induction process and the methods they were employing. (The new auditors had rapidly got up to speed in the UK and mostly also overseas, although progress was slower in the [✂], for reasons specific to that market.)

23. Whilst there was a greater level of inherent risk in the first year, the auditor would be expected to spend the time to understand the business so as to mitigate the risk. A prospective auditor's transition plan would therefore be a key factor in the decision whether or not to switch.

24. The ACC considered that the company had benefited from switching its auditor because it had received a significantly more challenging audit from the new firm.

Future tendering

25. The ACC said that the corporate view was that the company would be happy to tender in the future or explain why it was not doing so. It was helpful if the period between tenders was linked to AEP rotation. The ACC favoured returning to the former AEP rotation period of seven years, rather than the five years now recommended.

26. He was sure that if the AC, having weighed up the risks and benefits, wanted to tender the audit, it was likely to be able to do so, providing it could persuade the rest of the board. In response to CC questioning, the ACC said that it could be hard to push for a tender for reasons of corporate governance alone (ie in the absence of quality issues), due to the benefits of having an experienced and knowledgeable auditor already on board.

27. The ACC would be particularly concerned if regulations required companies to have different auditors in different parts of the world. This would be particularly detrimental to companies, such as those in financial services run on a global basis, where it was very important to have a lead AEP with a holistic view of the accounts. [✂]

Fee negotiations

28. Annual fee negotiations were generally led by the Finance Director and the outcome presented to the AC. The ACC would be worried if the fee was reduced too much, and it would be his responsibility to push back when such a situation arose. With respect to the impact of the need to change the fee, the negotiation would always begin with the previous year's fee.

Market developments

29. The ACC noted that two developments in the audit market over the last ten years or so had had an impact on the ability of audit firms outside the Big 4 to bid for tenders:

(a) Globalization of markets had severely reduced the number of firms capable of handling the audits of the top listed companies.

(b) The days of the generalist auditor were passing. The bigger audit firms were becoming more industry-focused. The knowledge a company expected from its auditors was vast, changing and growing (the ACC cited proposals to increase the role of actuaries). It took firms time to acquire this knowledge. However, this could be seen as an opening for a smaller firm to focus on, and invest in, developing an expertise in a particular area. The ACC accepted that a greater frequency of tenders could help this process, although it had been rumoured that some firms had refused to tender because they did not want to give up their long-term, specialized non-audit services.

Proposed remedies

30. On some of the proposals in the CC's remedies notice, the ACC said:

- Expanded remit and/or frequency of AQRT reviews: the AC factored these reviews into its considerations, but the ACC would not see benefit in the review system being further developed.

- Strengthened accountability of the external auditor to the AC: for example, in taking responsibility for the negotiation of fees. At the moment, the negotiations with the auditors were transparent to the AC but it would be practical for the ACC to negotiate the audit fees. The ACC was doubtful that this would change much in practice since the ACC would have to rely on the executive to explain the detail (eg on systems) that was important in deciding the scope and audit approach; if, for example, the bidding audit firm gave a fee estimate for a particular activity, the ACC would have to find out precisely how that activity was organized.