

STATUTORY AUDIT SERVICES

Summary of calls held with Company S

CC note

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

Company S is a constituent of the FTSE 350. On formation, Company S had inherited two auditors from different parts of the original business, one a mid-tier firm ([§]) and the other a Big 4 firm ([§]). The company held a tender to establish a single auditor for the entire business.

Views of the Finance Director

Tendering

1. The company decided to tender its audit services contract soon after being formed because it thought it was untenable to have two auditors for the business, given its overall size and that, under the previous group structure, the group of subsidiaries audited by the mid-tier firm was only a small element, whereas in Company S they accounted for approximately half of the business.
2. The Finance Director (FD) considered that Company S operated in a relatively simple sector and so was a little surprised that the audits for large and mid-size companies in the sector were almost exclusively concentrated among two Big 4 firms.
3. When the company decided to tender for its audit services, it did speak with a number of firms including Big 4 and Mid Tier, but considered that the only firms that had sufficient expertise to compete for its audit were the two Big 4 firms which already had virtually all the mid-cap audits in the sector. On that basis, it only invited three firms to participate in its tender—its two incumbent auditors and another Big 4 firm ([§]). It was important to the company to have an auditor that understood the industry and it did not want to risk having to educate a newcomer to the sector about the nuances and specifics of the sector. Certain accounting standards were of particular relevance to the sector and the FD thought that one reason for the concentration in the audit market was the technicality of IFRS, as firms had to invest to obtain the required expertise.
4. The FD said that he knew that the firm that was not its incumbent could do the job because it audited half the sector. This was not the case for any other firm.
5. The tender process lasted for a period of approximately six weeks. The FD found the process very time-consuming for himself, the senior members of his finance team (approximately seven to eight people) and senior business heads in his organization. He estimated that for the six-week period, the tender occupied approximately 20 per cent of his time and 50 per cent of his finance team's time, plus a significant amount of time of other senior business heads. The FD considered that the process was much more time-consuming than expected.
6. The tendering firms were given more or less unfettered access to himself and his finance team. He considered that they were quite sensible about speaking with

business head colleagues, but they all wanted to spend time asking questions. Information was provided to the firms on an ad hoc basis, although in his view the firms relied mostly on published information, particularly since the company had very recently published a detailed prospectus which contained a significant amount of information.

7. The FD considered that it would have been difficult to conduct the process in less than six weeks, with three firms being involved. The FD, Audit Committee Chair (ACC), and Chairman of the Board attended all the presentations and collectively made the decision on who should be appointed as Company S's auditor.
8. Each firm circulated its pitch documents about a week in advance of its presentation; this led to some follow-up questions from the decision-makers ahead of the presentation. The company measured each firm against a defined list of criteria. These were:
 - (a) capability of the team and choice of staff;
 - (b) experience and reputation;
 - (c) fees;
 - (d) audit approach;
 - (e) understanding of the business and challenges facing the company;
 - (f) approach to technical issues and judgements;
 - (g) non-audit services capability;
 - (h) financial vulnerability of the firm;
 - (i) approach to independence; and
 - (j) proposed handover plan.
9. In the FD's view, the three most important criteria were: capability of the team; understanding of the business; and approach to dealing with technical issues and judgements.
10. The company informally scored against each of these criteria. Based on this scoring the company considered that there were two firms that were clearly ahead out of the three that had been invited to tender. The one that ranked the lowest (the Mid Tier firm) failed to demonstrate breadth and depth of experience and failed to demonstrate appropriate knowledge of IFRS (as opposed to UK GAAP). The FD indicated that it was a close-run competition between the remaining two Big 4 firms.

Switching

11. It was the FD's view that if it had appointed one of the incumbent auditors as group auditor without a tender, the auditor would not have redeveloped the audit approach to consider the company in its own right, rather treating it as a spin-off from its former parent. He noted that one of the incumbent auditors had been quite defensive early on in the process and did not like having to repitch for the business. However, during the tender process, it had paused for thought about the challenges of the new organization.

12. The FD considered that the tendering process had been hugely beneficial: fees came down; got the appointed firm focused on what the business needed; and forced the company to consider what it considered to be the most important facets of the audit service. The fee was reduced in the region of 25 to 30 per cent. The FD said that he expected this, since previously, when the company had two auditors, the group auditor would review the work of the main subsidiary auditor. He sensed that the group auditor was uncomfortable at having to take responsibility for another firm's work.
13. All the firms submitted similar fees, although the Mid Tier firm was the cheapest by about £10,000. The company had agreed a fixed-fee formula for the audit, which included an amount for the top company audit plus additional amounts for each subsidiary. As the nature of the business was subject to lots of change, the final audit fee was agreed on an annual basis. The FD said that the fee had increased over the years since appointment as the number of its subsidiaries had also increased.
14. Following the appointment of a single auditor, the FD considered that he had better visibility of the main subsidiary business. He said that communications from all parts of the business into the group were also better. The appointed auditor did not take long to get itself up to speed with all parts of the business and the switch was not considered particularly disruptive. However, the FD was not planning to tender for the audit again in the near future, mostly because of the commitment levels required for the exercise of him and his team.

Remedies

15. The FD considered that it was sensible for the CC not to pursue joint audit. Having experienced joint audit, the lines of demarcation for the audit tended to cause difficulties and it was tough when one firm had to take responsibility for another's work. The Audit Committee (AC) was unlikely to be happy if the group auditor simply took a joint auditor's work on trust.
16. The FD would be nervous about having a more controlled tender process with data rooms because of the risks of confidential business-sensitive information being leaked. Also, he considered that firms' technical capabilities could only really be tested if they were allowed to get into some of the details, which a more controlled process may not facilitate.
17. As a user of audit services, the FD felt that the concentration of audits to just four firms was a big risk and was unhealthy and undesirable. However, he thought it would be difficult to put remedies in place to resolve this.
18. Whilst the FD considered that the current audit report was very binary and did not provide any real information, there were risks that greater reporting might not be very useful for investors. In his view, only a very small number of equity market participants read annual reports. There was lots of other information available to investors and many investors tended to focus on information that was not actually audited (ie preliminary announcements). He considered that as IFRS increasingly required technical understanding, the accessibility and thus utility of the financial statements was decreasing. The FD considered that making the AC report more interesting for investors was difficult without disclosing commercially sensitive information.
19. The FD considered that tendering was sensible and should take place at reasonable intervals. The Financial Reporting Council's ten-year proposals sounded sensible. However, the FD was not in favour of mandatory rotation. This would have left Company S, in the FD's view, with a choice of only one firm (if it could not have

appointed its incumbent). The FD did not believe that taking choice away was a good thing. He considered that Mid Tier firms needed to be tactical about developing their capabilities; he doubted that they could build up expertise in all sectors.

20. The FD said that tendering was effective, as long as it was not conducted in a 'box-ticking' fashion. A proper tender process forced companies to think about their audit services and what it was they wanted from them. It was good to review a company's suite of advisers but often other business activities took priority.
21. Opening up audit files might have adverse consequences and encourage less information being included in the relevant documentation. The FD was not confident of such risks being managed by non-disclosure agreements. He said that he would not invite certain firms to advise the company because they acted for competitors.
22. On the CC's proposals in relation to the AC, the FD noted that the AC appointed the auditors and the ACC was aware of all issues that cropped up during the audit. Only in rare circumstances would executive management not consult the AC. The FD considered that it was very difficult for management not to be involved in auditor appointment and fee negotiation; the AC was not executive management. The FD would be concerned if powers were diluted away from the AC towards investors, thus undermining the AC.

Views of the Audit Committee Chairman

In giving evidence to the CC, Company S's ACC drew on experience in equivalent positions at other FTSE companies in the financial services sector.

The property company

23. The ACC noted that whilst the company used two audit firms, one firm ([REDACTED]) had been responsible for the group audit and one discrete part of the business ([REDACTED]), while the other ([REDACTED]) had audited the other part ([REDACTED]).
24. [REDACTED], the company scrutinized the services provided by all its advisers. The AC had discussed which firms to invite to tender for a single audit contract across the whole company and had decided to invite the two incumbent firms plus one other Big 4 firm. All the candidates faced a substantial learning challenge; the two incumbent auditors of each discrete part of the business had to familiarize themselves with the business activities of the other part; and the additional bidder had to learn about the whole company.
25. The tendering process began with a series of interviews with senior management, especially those working on financial matters, and with each member of the AC. The three candidate firms next provided a written document, which was read by all the AC members. The final part of the process for each firm was a presentation to the AC. Bidding for the tender was a significant investment for all three firms.
26. The ACC reckoned to have spent about 30 hours, additional to normal activities, over about three months. The time that would be spent on the tender had been considerably underestimated at the outset, probably to the tune of about half the actual cost. The accounting department had borne the brunt of this, having to brief two new firms on the company's systems and activities. The unbilled costs by the audit firm must have been significant.

27. While the quality of the three firms impressed the AC, the selection of one of the incumbent audit firms ([X]) was based on the AC's perception of its marginally superior technical expertise. Choosing an incumbent was also perceived to be less risky.
28. The ACC said that having a single auditor brought clarity to the audit. If there were two auditors, each would have to check the work of the other since the two parts of the business were both substantial [X]. Having two auditors would also have involved considerably more ongoing work for the ACC than was involved in dealing with a single auditor.

Tendering at a FTSE financial services company

29. The ACC said that the company had looked closely at its audit arrangements frequently. There had been a full tender seven years ago and a partial tender four years ago.
30. For the full tender, involving written submissions and interviews with the AC, five times as much time had been invested as anticipated, with each bidding firm crawling over the company to find out how it worked.
31. The result had been closely contested by [X] and the incumbent [X] (both Big 4 firms). The risk of change had led to the choice of the incumbent; the challenger would have had to be far ahead in terms of competence and skills to have overcome this factor.
32. The 'partial' tender [X], involving the sending of letters to three of the Big 4 firms, was a means of 'sharpening up' the services of the incumbent by using the threat of a full tender with the aim of obtaining a more robust, independent approach. It resulted in the incumbent committing to more robust and detailed audits, providing greater insights into how decisions within the company were taken and into the strengths of the company's controls, processes and systems and what aspects of the financial statements were driven by manual accounting estimates. As part of the new approach, the auditors, in addition to their routine audit visits, met the ACC and FD seven or eight times a year. The partial tender had also resulted in some reduction in fees. The ACC said that the relationship with the auditors had worked well in the years since the partial tender.

Switching costs

33. The ACC said that the risks inherent in switching audit firms, in the financial services sector in particular, were significant for companies. The knowledge an incumbent auditor had of the systems, cultural issues and ways of working of a company could not be acquired by a new auditor for the first year or two. The ACC thought the advocates of mandatory rotation understated these risks.
34. If an AC were dissatisfied with the performance of the audit team, the ACC said, it should probably start by asking for a new audit partner to take over the audit and only if that did not achieve the improvement sought, it should look for further solutions with the incumbent firm. Rotation of the audit firm should be the last resort.
35. The ACC accepted that the risks of rotating audit firms applied particularly to financial sector companies but they were present to a lesser extent also in other sectors, especially for global companies.

Other possible remedies

36. *Mandatory tendering.* The ACC would have no hesitation in going out to tender if auditing arrangements needed to be sharpened up. An AC had the power to order a tender without any mandatory underpinning. It took such decisions after calculating the costs and risks involved. The principle of a 'comply or explain' rule was fine and largely led to compliance; a company might try explaining for one or two years but would ultimately comply.
37. *Expanded remit and/or frequency of Audit Quality Review team reviews.* The ACC considered that the review system worked 'about right' at present but had some reservations on the quality of Audit Quality Review and would not want to see it extended to include reports on individual firms. That would risk undermining the process.
38. *Strengthened accountability of the external auditor to the Audit Committee.* The ACC said that nothing was more important to audit firms than their independence. If a lack of independence ever arose, this was 'bad auditing' and it was incumbent on the company to take action to deal with it. (The ACC commented that, while the audit firms and regulators had been generally blamed for the banking crisis, the banks' directors had an equally important duty to be vigilant.)
39. *Enhanced shareholder–auditor engagement.* In the ACC's experience, shareholders had limited interest in a company's audit firm. It was doubtful that shareholders would intervene at AGMs on the subject of the auditors. In many years as an FD in the past, the ACC had never been asked any question by a shareholder about the accounts. The ACC had no issue in being required to present to the AGM.