STATUTORY AUDIT SERVICES

Summary of calls held with Company T

CC note

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

Company T is listed on the LSE and is now in the FTSE 100.

One of the Big 4 auditors, [✂], had been the company's auditor for over 20 years.

The company completed an audit tender process and in 2010 switched its auditor from one Big 4 firm to another, namely from [✂] to [✂].

Views of the Group Finance Director

Complexity of auditing the company

1. The Group Finance Director (GFD) stated that auditing the company was a reasonably complex undertaking owing to the nature of the business, specifically:

    (a) the company had [✂] operating divisions, each of which had approximately [✂] business activities; and

    (b) the company had approximately [✂] individual statutory entities, each of which required a set of statutory accounts.

2. However, the GFD did not think that there were any significant complex accounting issues associated with the production of the financial statements.

3. The GFD estimated that a relatively small proportion, around [✂] per cent, of its business was based overseas.

Tendering

4. The GFD's rationale for tendering the company's audit engagement was based on a desire for its auditor to 'add value' to the business by providing useful commercial feedback and going beyond solely providing the audit service. The GFD had a general sense that the incumbent had become complacent with respect to the overall level of service provided. When the incumbent failed to respond to the company's requests to improve the service provided, the GFD decided to test the market.

5. Three Big 4 firms were invited to tender (including the incumbent): [✂]. The bidders were selected because they had an existing relationship with the company or had had a relationship with it in the past (eg [✂] had previously undertaken tax work for the company). The GFD stated that the incumbent did not have any particular advantage in the bidding process and did not seem to be very responsive to the company's needs in the tender process.

6. The tender process took approximately six months to complete from start to finish. The GFD said that there were limited cash costs associated with a tender exercise.

With respect to staff time, the burden fell on the Group Finance Controller (GFC) and his immediate team. The time spent on the tender process by the GFC could be measured in terms of hours. Each of the three bidding firms held an hour-long conversation with at least half of the company's [✂] divisional heads. This process was governed by a timetable, which effectively capped the amount of staff time that could be utilized, though the GFD was unable to estimate the amount of staff time.

7. The tender process did not cause significant disruption to the company. To minimize disruption, the tender process was timed to ensure that the newly-appointed auditor would have sufficient time to begin work prior to the end of the financial year.

8. Each bidder was invited to make its case for appointment in a presentation attended by the GFD, the entire Audit Committee (AC) and the GFC. The final decision was made following a discussion on the merits of each bid and each bidder was ranked in order of attractiveness. Ranking was not undertaken using a quantitative methodology.

9. The GFD did not consider that there were aspects of the tender process he would have changed with the benefit of hindsight, and felt that the process had been appropriate and proportionate for the needs of the company.

10. The GFD said that he would not contemplate a further tender for another ten years. The right period was essentially a judgement. The GFD considered that an auditor needed time to get to know the nuances of the business and this would take at least one year. It was after this period that the 'value add' aspect of the relationship would become fruitful. Moreover, while the tender process was not the most onerous from the company's perspective, the GFD pointed out that there was still an opportunity cost for senior staff time.

Switching

11. The GFD did not consider that there were any particular complexities, costs or risks associated with the tender beyond simply conducting the process. The GFD stated that it was a significant decision to go to tender because there was a benefit to retaining an auditor that knew the business well—it was for this reason, as opposed to cost, that tendering should not be done too often. In the opinion of the GFD, the cost of tender fell more on auditors and not the company.

12. The GFD estimated that any additional hours that were necessary to spend with the new auditor in the first year of its appointment were not too significant. It was common that new members were added to an incumbent audit team year on year and, to this extent, it was necessary to educate these new members about the business of the company in any event. Accordingly, while switching to a new auditor could add a number of additional hours in the first year, that number was not much more than the usual process. The new auditor's existing relationship with the company meant that it was up to speed with the workings of the business relatively quickly, and from the GFD's perspective, he spent only a number of hours with the new auditor during the planning phase.

13. Switching to a new auditor resulted in a first-year fee reduction of [✂] per cent. The audit firm did not seek to claw back the cost of the tender—the GFD presumed that standard fee rates would factor in in tender costs over the long run in any event.

14. In the GFD's experience, the benefit of the first-year fee reduction dissipated by the third year of the new auditor's tenure. This was a result of organizational changes which changed the audit scope and resulted in fee rises. In addition, the auditor

might seek to renegotiate fees to take account of any unforeseen complexities. All this meant that comparing a like-for-like audit fee was difficult.

15. The GFD thought that audit firms (and audit partners) had similar profit expectations so unless one firm could find a way of doing things differently, there was unlikely to be much difference in fees between them.

16. The GFD had not had high expectations of the benefits of switching. He wanted a firm which would comment intelligently and which had the right culture to encourage this. He thought that he had gained additional insights as a result of switching auditor. Switching auditor had not affected audit quality because all the Big 4 firms provided a high-quality audit.

17. The GFD noted that since the FRC began conducting Audit Quality Reviews (AQRs), auditors were very careful to uphold audit quality.

18. The GFD did not consider that an increase in FRC resources was necessary, as firms knew that they might be selected for review, and were highly cautious as a result.

Views of the Audit Committee Chairman

19. The interviewee became a non-executive director of the company in June 2010 and took over as Audit Committee Chairman (ACC) in November, participating in the latter stages of the tender process and in the decision-making process.

Tendering

20. He had attended a board meeting to ratify the decision to go out to tender. The board had heard from the Group Financial Officer (GFO) that the work of the incumbent auditor had become commoditized and a routine exercise. There was no issue with the quality of the firm's audit work technically but the company's management considered that it was no longer getting any 'value add'. For example, they thought that the auditor could give advice on possible control improvements within the company based on its knowledge of developments in the outside world; and could introduce new tools to develop the audit process. Whilst the Chief Operating Officer had been against going out to tender because of the 'hassle factor', the CEO and AC members had been happy to proceed on the advice of the GFO. It had been a collective decision.

21. He had provided some advice on the design of the tender documents drawing on his previous experience of running a tender in 2008 as Chief Financial Officer (CFO) of another company [✂] (see paragraph 26 below).

22. As ACC at the company, he was actively involved in the assessment of the tender bids. He had held individual meetings with the prospective lead partners from the three contending bidders: [✂]. These were followed by formal presentations by the three firms before a panel consisting of senior executives, including the board Chairman and GFO, the ACC, a non-executive director and the GFC. The panellists came to a decision as a group, in a collaborative and consensual manner. The ACC felt that he had a strong voice in this process. The CFO knew what he wanted to get out of the tender, in terms of a fresh approach, but would not have pushed his view without the support of the rest of the board.

23. If, hypothetically, debate within the panel had become deadlocked, the ACC speculated that it would have been likely that the Chairman of the board, the GFO and the ACC would have sat down to go through the arguments once more. The ACC said that he would have argued fiercely for his viewpoint if convinced of it. If an impasse had continued, it would be likely that the bidders would have been invited back to make further presentations.

Previous experience of tendering

24. The circumstances in which the ACC had previously been involved in a tender for an external auditor (see paragraph 21 above) were where two similar [✂] businesses, each with a different auditor, had come together. The level of disruption involved in tendering for a single auditor for the merged business was not high since the systems of the component companies were similar and both firms were familiar with them. The selected auditor absorbed the work of the replaced firm [✂].

25. At another company at which he chaired the AC [✂], a decision had been taken not to go out to tender because the lead partner of the incumbent firm was being rotated and the firm's approach to the audit had undergone significant change.

The value and timing of tendering

26. The ACC considered that the financial and opportunity costs in terms of management time were exaggerated and should not be used as an excuse not to tender. The costs could be minimized by a well-designed tender process. Moreover, if the process was well designed, the company could learn a great deal, in terms of understanding the different suppliers in the audit market and their approaches to auditing different parts of the business; the use of different auditing tools (eg data analytics); and approaches to planning and communication. This had been true for the ACC at both Company T and in a previous company (paragraph 24 above), where the lessons learned in conducting a tender had been progressively absorbed within the audit process. Even if the company decided not to change, the process would be likely to enhance the audit quality.

27. Since he regarded tendering as a sensible and constructive discipline, the ACC had no issue with the proposal for mandatory tendering. He thought a six-year period between tenders was reasonable. Although there were a host of reasons why companies would want to go out to tender, including dissatisfaction with incumbent auditors, it was generally good practice for an AC to consider if and when to hold a tender, and this practice would be enhanced if enshrined in governance rules.

Reappointment of auditors/ongoing ACC work

28. The ACC managed and coordinated the work leading to the annual reappointment of the external auditors. This was a collective AC decision coming out of several processes:

    (a) frequent meetings between the auditors and the AC, and less frequent meetings with the audit partner and the ACC;

    (b) AC discussions with executive management, including the GFO and the GFC;

    (c) discussions within the AC;

(d) external assessment of the AC. An external company was commissioned to undertake this about a year ago. It sent a questionnaire to the AC, the board, the auditors and to finance staff with exposure to the AC. The external company produced a series of recommendations, which were currently being implemented. The ACC stated that external assessment was not a requirement but he considered it best practice;

(e) the ACC also completed an annual feedback check-list to help evaluate the performance of the auditors, answering standard questions such as: did the auditors confirm their independence? Did they check that that company was applying its policy on non-audit service fees?

29. The ACC said that his influence was as strong at the annual reappointment decision as it was during the period of a tender.

30. The GFO took soundings and was consulted on the decision but it was not his decision alone.

Switching costs

31. The ACC had to spend twice as much time on Company T's business when the new auditors were first appointed than he spent during a normal year. He saw this as time well spent. The audit team had to go through a significant induction programme involving many parts of the company. Much of this work programme had to be condensed so as to enable the auditors, appointed in August 2010, to complete the audit by the year's end. The ACC, also relatively new to the company, held many meetings with the audit team during this period to exchange views on areas of the business on which he or the team had concerns.

32. There were pros and cons in bringing a fresh pair of eyes to bear on the affairs of a company. A strong point in favour was that a new auditor could provide insights that the former auditors may have overlooked. On the other hand, it took some time for a new auditor to reach full technical proficiency. Performance in the second year would be better than in the first year and it should go on improving every year, by progressively smaller increments. However, if forced to choose, companies would generally rather have an incumbent in place for a period of time than regularly go through the process of inducting a new firm.

Non-audit services

33. It was helpful if an audit firm to a company had some knowledge of the sector in which the company operated. However, that had often led to the audit firm having the potential to provide other, non-audit services to that company. All companies should have a strict policy to ensure that the independence of the audit firm was not compromised in this way. At Company T, there was no discussion of non-audit services when the appointment of an external auditor was being considered, and the AC considered all bids to provide these services case-by-case. For example, Company T's auditors, using a different parts of the firm's organization, had been cleared to undertake some other work for the company (eg on mergers and acquisitions).

Other possible remedies

34. The ACC's views on other possible remedies can be summarized as follows:

(a) Mandatory tendering: strongly in favour, say every six years (see paragraph 27 above).

(b) Mandatory rotation of audit firm: not in favour but agreed that ACs should explain why they were not rotating the firm.

(c) Expanded remit and/or frequency of Audit Quality Review team reviews; in favour of this as enhancing good governance and promoting greater disclosure; believed shareholders would favour an extension of the coverage of the reviews, with a stronger focus on the quality of, eg, judgments, evidence and documentation. (The ACC had found AQRs useful in some respects, although noted they could be pedantic in others.)

(d) Prohibition of 'Big 4 only' clauses in loan documentation: in complete agreement.

(e) Strengthened accountability of the external auditor to the AC: the ACC thought this was a difficult issue, raising the wider issue of changing the role of non-executives.

(f) Enhanced shareholder–auditor engagement: the ACC expressed some support for this, which could contribute to improved checks and balances in the relationship between the company and its auditors.

(g) Extended reporting requirements; the ACC had no issue with this possible remedy and noted that some changes in this area are in train. He considered that it would be helpful to include in reports more disclosure as to how particular accounting treatments had been decided on.