Financial Reporting Council

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Audit Tenders

Notes on best practice

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Introduction

1. Over recent years, discussions about the operation of the audit market have focused on audit tenure; the longevity of audit firm relationships with the companies they audit. These discussions have included a debate about the relative merits of mandatory audit firm rotation and a requirement to tender the audit engagement on a periodic basis.

2. As the independent regulator responsible for promoting high quality corporate governance and reporting in the UK, the FRC seeks to promote high standards in audit. If that objective is to be achieved, the FRC believes that a company should be able to retain the firm that it believes is best able to undertake its audit. The FRC therefore believes that tendering, not mandatory audit firm rotation, is the appropriate way forward. Tendering provides an effective way by which companies can examine whether they have the best auditor available, yet does not preclude the reappointment of the incumbent auditor if that firm is demonstrably the best able to undertake the audit. Tendering also has the potential to stimulate innovation in the way audits are conducted as audit firms seek ways to demonstrate the merits of their audit tender.

3. For these reasons, in October 2012 the FRC updated the Corporate Governance Code and introduced a new provision, on a comply or explain basis, requiring FTSE 350 companies to put their audit out to tender every ten years.

4. Audit Committee Chairmen and others have asked the FRC to provide some practical examples of how an audit tender might be conducted. We organised three roundtables where key market participants – including Audit Committee Chairmen, investors, Finance Directors and auditors – could air their views and share their experiences of tender processes. This document arose out of those roundtables and is intended to provide companies and Audit Committees with some real life examples which they may wish to consider as they design their own tender processes. We are keen to reflect and encourage a diversity of approaches, rather than recommend a particular path and so we have resisted some calls to publish guidance.

Deciding when to tender

Be clear about what you want to achieve and talk to major shareholders early on

5. In the past, companies changed auditor relatively infrequently. When tenders did occur they were often the result of such things as:

   - A merger, acquisition or other major change in corporate structure;
   - A change in the company's leadership team prompting a review of advisory relationships more generally;
   - Perceived poor service from the incumbent auditor;
   - A personality clash between the audit partner and company management;
   - Disagreement between company and auditors on particular accounting treatments.

6. Only rarely were tenders seen to be as a mark of good governance. The Code provision for FTSE 350 companies to put their audit out to tender every ten years changes that.

7. Many FTSE 350 companies have indicated their intention to align the timing of tenders with the audit partner rotation period, i.e. at the end of the second audit partner's five year tenure. This makes sense - but there is no requirement to adopt that course and companies may tender more frequently if they wish.

8. An intention to tender should be disclosed in advance, perhaps through the Audit Committee section within the annual report. Depending on the nature and complexity of the business some Audit Committees may consider it desirable to disclose the intention to tender a year or more ahead of the process. This maybe of relevance to some financial service companies, whose auditors face particularly complex independence requirements. Such advance notice supports the notion that tenders are part of the normal business cycle, rather than a flag to investors of concerns or issues in the audit relationship. Likewise where the provision is not to be complied with and, instead an explanation given, we would encourage companies to engage with shareholders on this issue.

9. In any event we would expect most companies would wish to time their tender so that it is completed in time for the AGM resolution on auditor appointment.

Understanding your objectives

10. There are a number of reasons why a tender might be initiated:

- Good governance, ie stimulating independence and objectivity and inviting a fresh look;
- Complying with the Code;
- Major change in the size, structure or geographic focus of the group;
- Testing the market place on service and price;
- Stimulating the incumbent audit firm.

11. Setting clear objectives is an important part of a successful and focused tender process. It is important that the decision makers are in agreement about their objectives from the outset. It can also be helpful if the key objectives are included in the Request for Proposal (RFP).

12. It is also helpful at this early stage for the selection panel to agree the selection criteria and assessment mechanism; the objectives and selection criteria go hand in hand. It is difficult to be clear on the second without being clear on the first.

Who to invite

Develop clear criteria that are right for the business. Reputation alone is not sufficient. Seek investor views

13. Most companies choose to invite certain firms to participate in the tender process. It is clear that there are many ways of determining which firms to include. Reasons that have been given to us for the initial shortlisting include:

- The reputation of a firm.
- The geographical coverage of a firm's network.

- Previous knowledge of a firm, perhaps from an audit performed elsewhere or through non-audit work for the company.
- A firm's knowledge of the industry sector and/or regulatory environment.

> Company A obtained a list of the 15 largest UK audit firms and examined their current client lists and hence their industry experience. It then reviewed each firm’s coverage in its critical territories. Based on this exercise, it invited five firms to participate in the tender.

14. The feedback we have received indicates that typically three to five firms are invited to participate in the tender, balancing choice with the practicalities of carrying out an efficient and cost effective process.

15. Companies may consider it appropriate to consult their major investors at an early stage to determine whether they have views on matters such as the outcomes they would like to see from the audit; the audit firms that should be invited to tender and the success criteria that the company should use in the course of the tender. Investors at the roundtables told us that they would welcome this.

> Company B announced its intention to put its audit out to tender at an early stage. Following this it opened a dialogue with a number of firms, including meetings to discuss issues relevant to the audit. It went on to award small pieces of non-audit work to each of the firms in order to test the quality of the firm and its people. Following this exercise a shortlist was produced.

16. The question of “reputation” is contentious. Audit Committee Chairmen have in the past told us that they find it difficult to distinguish between audit firms and often use size or brand as a proxy for quality. However, other firms may well be able to do a high quality audit. At our roundtables, investors stressed they would welcome a wider range of auditors being selected including outside of the Big Four. However, all agreed that selecting the firm who will provide the highest quality, most robust audit is the prime consideration

17. Audit Committee Chairmen stressed that the key objective should be to choose firms which appear right for the business. For example, if the majority of the company’s operations are domestic, there may be no need for an audit firm with a large global network. Equally, if the company’s overseas operations are concentrated in a small number of territories then the focus should be on the strength of each firm’s network in those specific territories building in future growth plans as appropriate; not on its overall global coverage.

> Work with potential auditors to ensure they are free to compete under independence rules

18. Audit Committees and auditors have also stressed the need to be mindful of the potential for independence issues. For example, if a firm is already providing particular non-audit services, it may not be able to continue with those services and act as auditor. Financial and business relationships between the company and the firm or its partners may also be problematic. Issues can arise in respect of non-audit work

carried out both in the UK and overseas and the interplay between different national rules can be complex. Prospective auditors should be able to satisfy the company and its Audit Committee that they have considered all potential independence issues and have a clear programme for being independent by the date of appointment.

Running the tender

Audit Committee leadership is essential. Access to key personnel needs to be available and coordinated

19. Once a shortlist is produced the tender process begins in earnest. There are a variety of approaches to these processes

In the case of Company C, the entire process, from the decision to tender to the final recommendation to the Board, was run by the Audit Committee Chairman.

Company D, a large and complex company with major operations in Europe, Asia and the Americas, was concerned to ensure a robust and effective process, which did not require an unreasonable amount of directors' and staff time. The company engaged an external firm of consultants to manage some operational aspects of the process, including the organisation of meetings and access to the data room. The consultancy was not involved in decision-making.

20. Many companies send out lengthy questionnaires and/or request detailed capability documents from potential auditors. Whilst both of these can be useful, companies are finding it best to be clear what they are looking for in a potential auditor from the outset of the process, how that might differ or resemble the service they are currently receiving and what the success criteria will be. If a questionnaire is used, it has been suggested to us that companies should consider carefully the relevance of each question asked to the objective of the tender.

21. The almost universal view from attendees at our roundtables was that the Audit Committee should own the process and this aligns with the spirit of the Code. This does not preclude certain operational matters being left to the finance function and/or external consultants, but it is essential that the Audit Committee Chairman should lead the process.

22. This is a position with which the FRC agrees. Research carried out by us in 2009 and again in 2011 suggested that in many cases audit tenders were driven and led by the Finance Director. Whilst the input of the Finance Director and his/her team is of great importance, best practice is clearly that the Audit Committee and its Chairman take the lead and have the final say on the recommendation to the board.

23. Some companies find it helpful to have the procurement function/specialists involved with the tender process to ensure that an independent and objective process is undertaken. However, the most important issues in an audit invariably require the exercise of judgement and the Audit Committee needs to ensure that the process

adopted gives adequate weight to the ability of the candidate firms to exercise judgement on audit issues. Leadership from the Audit Committee is key.

24. For a tender process to be effective information needs to be provided to the prospective auditors. Providing an adequate amount of information allows firms to better understand the potential client's business and to focus on the key risk areas. It also helps to mitigate the incumbent firm's advantage. If the process is to be seen to be fair and objective, it is important that there is a level playing field between the tendering firms.

25. There are various ways to provide this information and some companies find that face to face Q&A sessions are more effective than access to detailed financial information. This does need to be balanced with the need to minimise disruption to finance and operational areas. Some companies have found it useful to appoint a single contact person to manage all information requests from the shortlisted firms. Increasingly online data rooms are being used.

> Company E provided all the shortlisted firms with access to a comprehensive online data room on a secure, password protected server. The information provided included recent company results and details of corporate strategy, information on corporate structure, systems and controls and risk management, together with its internal audit plan. The firms' final pitches were informed by the information obtained from this exercise.

> Company F signalled its intention to conduct a tender process three years ahead of the proposed change. Firms on its shortlist were given certain information and details of key contacts but advised to "respect their access" because the extent to which a firm did so would be a factor in the final decision.

26. The initial review of available information will typically be followed by a series of meetings with key personnel. Again, it is important that companies balance appropriate access with the need to avoid unnecessary disruption caused by frequent and repetitive requests for information and clarification.

> Company G organised an access day where the shortlisted firms were able to meet with individuals from key functions. This included finance and internal audit as well as other operational and global units.

27. A number of parties have commented to us that they have experienced tender processes which were very lengthy and expensive for all those involved. The challenge is to limit the time taken up by the process whilst allowing the tendering firms to get a good understanding of the company and the audit requirements. Providing vast amounts of information and a great deal of access does not necessarily lead to a better outcome. It is normal to advise the firms of the timetable to which the company is working.

28. It is common practice as part of the selection process for each firm to submit a written proposal which includes matters raised in the RFP. The feedback we have received

indicates that Audit Committees are discouraging tendering firms from producing very long and detailed written proposals.

Making the decision

Put audit quality, not price, at the top of your list. The role of the lead audit partner is key

29. Once the firms have obtained the information they need about the company's business and the risks it faces, they will develop and put forward their final proposals. Following that, the Audit Committee selects an auditor to recommend to the board for appointment.

30. All of those we spoke to agreed that quality was the key criterion; but defining what quality might mean was more difficult.

31. Prospective auditors may be able to demonstrate quality in a number of ways, for example:

- A clear understanding of the company's business, its industry and the related risks and the company's competitive position.
- A clearly articulated audit plan to address the risks identified including:
  - The materiality to be applied to planning and conducting the audit.
  - An explanation on how a high risk area, for instance, revenue recognition would be audited.
  - The approach to testing and reliance on controls.
  - The approach to and scope of component audits.
- The selection of a team of appropriate experience and seniority.
- Availability of specific audit tools such as data analytics.
- Practical examples of addressing specific and relevant issues at other clients.
- An explanation of what distinguishes their proposed audit approach from that of other firms.
- Demonstrating through the tender process constructive challenge and an appropriate degree of scepticism.
- How issues will be reported to the Audit Committee.
- Whether their audit will provide additional assurance beyond the statutory requirements and what this will involve in practice.

Company H gave the shortlisted firms a set of scenarios that required them to exercise judgement on particular issues.

32. Sometimes companies will ask shortlisted firms to review the last set of accounts and provide comment on the accounting treatments. This can be a useful test of an auditor's robustness and scepticism. It is not without its risks, however, as prospective auditors may feel pressured to concede on questionable accounting policies in order to secure the contract.

Don’t rule out incumbents without good reason

33. The FRC’s reports on the inspections of individual audit firms can also provide information on quality, and some of the firms’ own publications (such as their transparency reports) may be of use.

34. Much of the feedback we have received from Audit Committee Chairmen and from Finance Directors has suggested that the key factor in their decision is the quality of the audit partner. Some likened the process to a senior recruitment exercise and placed considerable emphasis on assessment of the lead partner. We were told that it is increasingly common for companies to organise dinners or social events to judge the “chemistry” between the prospective audit partner and the Audit Committee Chair and/or Finance Director. Investors expressed some disquiet at this trend as “chemistry” cannot trump all other considerations, such as auditors’ independence and objectivity.

35. In their proposals audit firms sometimes give the names of referees from existing audit clients. In the past the FRC has expressed concern about this on the grounds that it may pose a threat to independence at existing clients. However based on feedback we accept that references can be very helpful and are increasingly becoming common practice. Having the Audit Committee Chairman select who to approach for a reference provides an important safeguard.

36. There was general agreement that price is not the main factor or even a significant one. Sometimes pressure for lower fees comes from the finance function and Audit Committees may not always have provided the appropriate balance on price. Although the FRC has no position on price, it is concerned if lowballing results in a risk to quality. One suggestion made at the roundtables was that companies may wish to consider conducting the initial part of the process on a “price-blind” basis, although some wondered how achievable/ beneficial this might be.

37. Traditionally the final decision has been based on a presentation to the selectors followed by a Q&A session. This is still a popular way to conclude the tender process; although many companies now stress the importance of the earlier stages over an “all or nothing” final session. At this stage the Audit Committee will typically decide on their preferred auditor before putting a recommendation to the Board.

38. Typical evaluation criteria used at this stage in a tender process might include:

- Lead partner/team’s experience and performance.
- Appropriate audit team structure.
- Depth of understanding of the business, its industry and the risks.
- The quality of each firm’s understanding of the audit risk areas and approach.
- Cultural fit with the company.
- Specialist audit resource as appropriate.
- Where the company has significant operations overseas, appropriate geographical breadth and depth and cohesiveness of each firm’s global network.
- Any experience with the tendering firms.

- Importance of the company to the firm as an audit client.
- Approach to independence and conflicts.
- Detailed and well-articulated audit plan.
- Transition plan and experience of transitions.
- Clarity of approach and commitment to quality.
- Authority of the lead partner, his/her ability to make decisions and the influence he/she has within their firm.
- Ability to work with internal audit, compliance and the risk function and, as appropriate regulators.
- Demonstrated commitment and enthusiasm.
- Published report from FRC Audit Quality Review inspectors.
- Fees and the control of fees.

Transition

Allow sufficient time for an orderly handover. Plan the transition.

39. Some Audit Committee Chairmen have expressed concern about the potential for difficulty and disruption during the transition from the old to the new auditor, in the event that they decide on a different firm.

40. Almost all of the feedback we received from those who had gone through the process was positive. Very few problems in transition were reported, with the teams from both firms acting professionally throughout. A small number of issues were reported in terms of the speed with which information was passed from the old to the new team; clearly it is important that this is done promptly and the changes to the Audit Regulations requiring an outgoing auditor to provide all relevant information to the incoming auditor should have helped.

41. Involving the incoming auditor at key stages of the prior period's audit, for example the meeting with the Audit Committee to discuss the key issues emerging from the audit and on discussions to resolve significant issues can be helpful, but needs to be handled carefully so as not to affect the incumbent's independence.

42. Conducting a thorough analysis of accounting policies, systems and controls at a very early stage of the first year's audit can be an effective mechanism for the development of a comprehensive audit plan.

43. These issues can be factored into the tender process, for example with candidates asked how they will manage the first 100 days should they be appointed. There was feedback that clear planning and the appointment of a transition manager help.

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