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Introduction

We know from discussions with stakeholders that retendering and auditor rotation contributes to improved confidence in audit and we have also seen evidence of competition on grounds of audit quality. Thus, the FRC considers it a good time to update its notes on how best to support an effective tender process. This new document includes more emphasis on involving the whole Audit Committee in the process; engaging with the firms before the process starts to ensure that the right teams are presented; the long lead time required for an effective and smooth running process and appropriate engagement with investors.

The 2013 best practice observations were designed to help Audit Committees conduct a tender process following the October 2012 update to the UK Corporate Governance Code which required FTSE 350 companies, on a ‘comply or explain’ basis, to put their audit out to tender every 10 years. The Competition and Markets Authority later issued an order following the Competition Commission’s investigation into competitiveness in the FTSE 350 audit market requiring retendering. Since then, many companies have put their audit out to tender and further best practice has started to emerge.

Subsequently EU legislation, in the form of the Statutory Audit Regulation and Directive, came into effect on 17 June 2016. In the UK the Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR), has introduced a requirement for all Public Interest Entities (PIEs) to conduct a tender at least every 10 years and rotate auditors after at least 20 years.

The recent legislation contains specific requirements for PIE Audit Committees in respect of tender processes, including:

- Audit Committees must submit two possible audit firm options for the engagement to the Board, together with a justified preference for one of them.
- The tender process cannot preclude the participation of non-Big 4 firms.
- Ensuring that the tender process provides information to the participating firms that allows them to understand the audited entity’s business.
- Ensuring that the tender process uses transparent and non-discriminatory selection criteria to evaluate the proposals and that a report on the conclusions of the selection procedure is prepared and validated by the Audit Committee.
- The Audit Committee should consider the findings and conclusions of the public reports on the UK audit firms published by the competent authority (in the UK this is the FRC).

The FRC, as the UK’s Competent Authority, has responsibility for monitoring the effectiveness of Audit Committees, this includes the conduct of a tender process.
The ultimate goal of the tender process is to appoint the audit firm that will provide the highest quality, most effective and efficient audit; this document seeks to give ideas to Audit Committees regarding how to make the appointment process effective. Tendering can also be expensive in terms of time and resources for both companies and audit firms, so the FRC also provides Audit Committees with some ideas regarding efficiencies that could be made in the tender process.

In developing these notes, the FRC held roundtables with Audit Committee Chairs who had recently gone through an audit tender process or who were about to do so; representatives from the investor community and senior audit engagement partners from the Big 6 audit firms, along with specialists from their “bid-support” teams. We also drew on our own review of audit tender documentation and materials prepared by market participants.

Why undertake a tender?

Apart from the regulatory requirement, feedback from companies that have changed auditors since the change in requirements indicates that there are benefits to be gained from fresh insight. Even if the incumbent firm is reappointed, experience suggests that the tender process itself can reinvigorate the audit approach.

“I
Why didn’t we do this earlier?
”

Audit Committee Chair

Results of the FRC’s annual quality survey of Audit Committee Chairs indicated that undertaking a tender process was not as difficult as expected, particularly as the audit firms are now more experienced in undertaking tenders.

Timing of a tender

Since changing auditors is a significant undertaking for most entities and their Audit Committees, the timetable for the change should be on the forward agenda of the committee, some years in advance of the requirement to tender or to rotate. Factors to consider when determining the timing of the tender include:

- Future timing of changes in the Board, particularly of the Audit Committee Chair and Chief Financial Officer (CFO);
- Known operational or strategic changes within the business, including significant acquisitions and disposals or major IT system changes;
- Allowing a handover period or a period of ‘shadow working’ – for complex entities this might be an extended period;
- Co-coordinating with the tendering and provision of conflicting non-audit services (e.g. tax or internal audit work);
- Aligning the timetable for change with related entities; and
- Competition factors, including when competitors are likely to be conducting their own audit tenders.

It may be beneficial to tender the audit before the last possible date, in order to have a wider choice of audit firms and audit partners.
Timing of the tender may need to have regard to the interaction between differing rotation requirements where a group has PIEs in more than one EU jurisdiction. The UK requires retendering after 10 years and rotation after 20 years. Other member states have selected shorter time periods. The FRC and equivalent bodies in other EU jurisdictions have the discretion, in exceptional circumstances, to grant a maximum two year extension to the retendering and/or rotation period. Consideration as to whether such extensions will be available may be appropriate.

The Audit Committees of PIEs related to PIEs in other member states, should consider co-ordination of the tender timing around the group. The Audit Committees of subsidiary PIEs will need to be involved in the tender process to discharge their responsibilities.

In some cases, such as after an acquisition or restructuring, it may not be clear when the audit engagement began. The FRC, as competent authority, can be consulted and will opine on decisions as to when engagements began in these cases. FTSE 350 companies should also consult the Competition and Markets Authority.

Auditor independence requirements by the time of appointment, without unforeseen impacts on other services received by the company.

Entities that use several firms for different advice, should develop a long-term strategy for the procurement of professional services which ensures that at least two firms are able to participate in the audit tender process, and satisfy auditor independence requirements by the time of appointment, without unforeseen impacts on other services received by the company.

Engagement with investors

The conduct of the tender sets the tone for the audit relationship and Audit Committees must be able to demonstrate ownership of the tender process.

Investor representative

The ultimate clients of a statutory audit are investors, not companies and Audit Committees act on their behalf. Significant shareholders are therefore interested in a transparent tender process. Audit Committees are required to disclose in their annual report that a tender is taking place. If the timing of this information is not sufficiently in advance to give investors an opportunity to engage, Audit Committees should consider other ways of alerting shareholders to the start of the tender process. There are a number of points in the process at which a company can engage with its major
shareholders, but investors need to be aware at an early stage that the tender is taking place.

Companies should communicate with investors before the formal process commences and seek investor views to inform their choice of participating firms.

The UK Corporate Governance Code requires (on a “comply or explain” basis) Audit Committees to report on the length of audit tenure and give advance notice of retendering plans.

Investors welcome a clear announcement of the timetable for the tender process, including when the process will take place and which year-end will be the first for the new auditor. If the annual report timing comes too late in the process, companies should consider other forms of publication, as well as direct engagement with the largest investors.

Investors are interested in which firms are being invited to tender and whether or not firms outside the Big 4 are being considered. In particular, investors would like to know whether the Audit Committees of less complex entities are inviting firms outside the Big 4 to participate.

Another area of importance to investors is potential “conflicts of interest”. Investors recognise that conflicts of interest will occur, therefore they would like transparency regarding potential conflicts and how they have been mitigated and/or will be managed.

Engagement and transparency are equally important at the end of the process. A number of investors indicated that they would like to know what factors led to the decision, how conflicts are being mitigated and/or managed and what diligence was carried out, particularly in connection with the audit engagement partner.

The Audit Committee could also engage with investors regarding the nature and extent of the proposed reporting by the auditor; the standard gives considerable flexibility for innovation.

**Responsibility for the process**

The Audit Committee is required to present to the Board two possible options for appointment as statutory auditor, with a clearly justified preference for one of those options.

All members of the Audit Committee, not just its Chair, should have a good understanding of the legal requirements, the mechanics of a tender process and what the company is trying to achieve from the process. Companies could consider asking the Company Secretary or the incumbent audit firm (provided the incumbent will not be part of the process) to provide a briefing on audit tender processes to ensure all Audit Committee members understand their responsibilities.

Investors expect the Audit Committee to have significant involvement in the tender process and the process to be led by the Audit Committee Chair. Audit Committees should not underestimate the additional time that will be needed by all of the Audit Committee members during the tender process.

All members of the Audit Committee should be involved throughout the tender process.

> Audit Committees must have ownership of the tendering process and be able to demonstrate this.

> Investor representative

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3 UK Corporate Governance Code (provision C.3.8) – April 2016
4 This Code provision overlaps with Part 4 of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014.
Overview of the process

The tender process itself can be divided into a number of stages.

1 Before the formal process starts
- Selecting firms to involve
- Number of firms to involve
- Select the right audit team at each firm
- Define critical success factors

2 Tender process period
- Issue Request for Proposal (RFP)
- Provide access to data room
- Provide access to management
- Technical challenges

3 Proposal document

4 Presentation day

5 Decision making
- Scorecards
- Who makes the decision
- References

Before the formal process starts

A typical tender process, from Request for Proposal (RFP) to decision, takes around three months but pre-preparation time may be several months or years. A number of tasks should be undertaken before the formal process begins.

Selecting firms to involve

Audit Committees should consider a range of firms, both Big 4 and non-Big 4 and engage with investors on this topic.

Audit Committees should ask firms for their most recent FRC Audit Quality Review report at an early stage in the process to gain an understanding of the FRC’s assessment of the firms’ audit quality.

Other factors that may be considered, when selecting which firms to participate in the process, include their industry sector experience and the geographical spread of the company.

Firms should be asked to undertake conflict checks at this early stage in the process, as well as at the time of the RFP and immediately before the decision making point.

Number of firms to involve

A typical tender process involves three or four audit firms, however, in some industries, particularly financial services, many conflicts of interest arise which may make it difficult to identify more than two firms to be involved in the process. The legal requirement is that at least two firms are presented to the full Board by the Audit Committee, with a justified preference for one firm.

Select the right audit team at each firm

A crucial element of a firm’s proposal is the membership of the engagement team, it is important not to get to the end of the process and find that a firm is not considered for appointment because a member of the audit team is not the right fit. It is, therefore, becoming common for some “pre-selection” of the audit partners to take place.

Companies should be clear what skills and experience are being looked for in the engagement partner. Firms should be asked to put forward two or three partners at the start of the process for the Audit Committee to choose who should lead the tender process.
Audit engagement partners can only serve for five years before rotation is required.

Companies should ask firms to outline succession planning for their audit teams, to get an idea of the depth of talent within the firm, and given that there is a now a legal requirement for individuals in a PIE audit team to be subject to a gradual rotation process.

Investors and Audit Committee Chairs have expressed concern to the FRC that firms are using “star” audit partners to win audits who are then rotated off the engagement before the end of the five year term or who, in reality, delegate much of the audit activity to another partner.

Consider asking for a commitment from the firm to a five year tenure from the engagement partner and, in future years (when there is more history of tendering), requesting data on the length of time the individual partner has served in audit engagement partner roles.

**Define critical success factors**

An important element of the preparation process is for the Audit Committee to define the critical success factors for the audit proposal. These will be different for each company, but clarity on the key factors that will drive the decision making process leads to more focused requests of the audit firms and a smoother process. Critical success factors might include:

- Industry expertise of the firm and audit team;
- Experience and audit quality record of the lead partner and the firm;
- Planned use of technology in the audit process;
- Geographical coverage of the network firm; and
- Experience in transitioning similar audits.

**Structure of the process**

The ultimate goal of the tender process is to appoint the audit firm that will provide the highest quality, most effective and efficient audit. The process should be designed to provide the Audit Committee with at least two candidate firms with nominated engagement teams that the Audit Committee consider are good candidates for appointment. Therefore, one of the characteristics of an effective tender process is to build in “check-points” to ensure that the firms are on track to provide credible propositions at the point the decision is made, often on the day of a presentation.

Appoint an individual with responsibility for ensuring that all firms involved are progressing well. Depending on the circumstances of the company, this could be the Audit Committee Chair, Board Secretary or a member of the finance function.

It may also be effective to have a Steering Group overseeing the project, including the Audit Committee Chair, CFO and the individual charged with leading the logistics of the process.

International businesses need to consider whether the tender process will be very centralised and whether the views of local management will be taken into consideration when making the decision. There is a spectrum from a fully centralised approach to the tender where consideration of local teams is performed by the Audit Committee, to “mini-pitches” from local audit teams to local management, which feed into the overall decision making process.

Audit Committees should consider the appropriate level of involvement of overseas management.

5 Exceptionally this may be extended with the permission of the audit committee to no more than seven years, where a pressing reason exists e.g. to maintain audit quality in a period of change.
Elements of the tender process period

Start of the process

The formal start of the process is the issuing of the RFP. Some Audit Committee Chairs were unsure to whom at each audit firm to address the RFP. The firms are clear that an RFP can be sent either to an audit partner with whom the company has an existing relationship or directly to the Head of Audit.

The RFP should contain the key information regarding the tender process, such as timings and contact details, and the deliverables that will be expected from the audit firms. It should also include the selection criteria that will be used to make the final decision.

Provides access to data room

Data rooms are widely used in the tender process and are very effective at providing all firms with the same information. However, the level of detail can be overwhelming and may hinder firms in communicating their understanding of the business and proposed audit approach.

Entities should consult with the incumbent auditor in determining the most useful information to include in the data room. The incumbent auditor's most recent audit plan and audit scope were felt by audit firms to be extremely useful.

It is best practice to make the same people/teams available to all firms, even if the firm did not originally make a request to see a particular team.

Provide access to management

Access to management is another important part of the tender process, enabling firms to gain an understanding of the business, but also providing a valuable opportunity to assess the audit team members.

Entities should ensure that all firms are given equal access to management.

This can be managed in a number of different ways:

- A day (or more) of “speed-dating”. A number of different members of management are made available for meetings with the audit teams from each firm. The audit teams rotate around the members of management (and possibly non-executive directors too). The company can determine who is made available, the audit firms can be asked who they would like to see (or both). “Speed-dating” can reduce the time commitment needed from management, by containing the involvement to a specific period of time;

- Certain site visits being arranged for each audit team to visit local management; and

- An open meeting with all firms invited to ask questions of management. This has the advantage of limiting the amount of time needed from management, but limits the usefulness of feedback that can be obtained on the firms.

Technical challenges

“Technical” challenges are widely used in the tender process, either during the process – or on the day of the presentation itself, as they offer an opportunity to assess a firm on a wide spectrum of criteria. For example, an accounting and auditing challenge could be used to assess both the technical competence of the engagement team as well as the responsiveness of the central technical team. Questions on ethics and independence are also frequently used to appraise firms. All challenges set usually offer insights into a firm’s culture, such as how much advice audit partners typically seek before opining on a matter.

Audit Committees should consider what insight they wish to gain from setting a technical challenge and beware of appearing to be “opinion shopping”. In this respect, a forward-looking exercise, which seeks to assess the firms’ approach to the challenge is preferable to seeking a view on a matter already included in the financial statements or decided upon.
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Proposal document

RFPs usually include a request for a document to address a number of different areas. These documents can be very detailed. The production of these documents involves a great deal of effort by the audit firms and the proper analysis of the content requires considerable investment of resources by the company.

Audit Committees should aim to limit the document to a certain number of pages (20 is common practice) and should consider carefully what information it should contain and how it will be used as part of the decision-making process. It can be useful to nominate a member of management or the Board secretary to review and summarise the documents, highlighting key differences in the proposals.

Presentation day

Typical practice is to see all firms on the same day and allow between 60-90 minutes for each firm. Within this around half the time is likely to be allocated to the firm giving a presentation and the remainder to Q&A.

Best practice is that the whole Audit Committee attend the presentations.

Management, such as the CFO, often attend the presentation. Audit Committee Chairs must consider to what extent management contribute to the Q&A and the decision-making process.

Companies should consider who from the audit firms should attend the presentation, depending on the needs of the organisation and what aspects of the audit team they are seeking to assess:

- If an overseas subsidiary is particularly large or significant to the audit risk profile, the proposed Key Audit Partner for that entity could be invited.
- If the business has particular tax, actuarial, IT or other specialist needs, then the individuals in the team with those responsibilities could be invited.
- If the Audit Committee wants to assess audit team dynamics, then more junior members of the audit team could also be invited.

Decision-making approaches

Scorecards

Many Audit Committees develop a scorecard approach to rate the audit quality offering of the firms. This can be used during the process, for example to collect feedback from audit teams’ meetings with management, as well as during the final presentation and review of proposal document.

Audit Committees should consider what weight is given to management’s assessment of the audit teams – obtained from interactions during the pitch process.

Who makes the decision and how?

Audit Committees should consider the best method of decision-making, by vote or by discussion and whether the decision should be made on the presentation day or after a suitable time for reflection.

Audit Committees could consider seeing the presentations delivered by the audit teams on the day blind (without first reviewing the documents or other scorecard data) – and then comparing their assessment with that from the scorecards/document assessments.
References
It is increasingly common for companies to seek references for individuals involved in the audit. Practice varies between asking the firm to provide suggested referees and Audit Committees using their own networks to obtain informal references.

Audit Committees should consider the best approach to obtaining references on the individuals involved in the proposals.

Investors would like to know what due diligence has been done on the audit partner.

Investor representative

Audit Committees need to explain why they have made the choice they have made and how the requirements of audit quality were met.

Investor representative

Formal decision
The legislation requires the Audit Committee of a PIE to make a recommendation to the Board for appointment of an auditor. The Audit Committee must validate or approve a report on the tendering and appointment process. That report is to allow the audited entity to demonstrate to the Competent Authority (the FRC) that the process has been carried out independently and fairly, and in accordance with legislative requirements. It is a decision for the Board of the audited entity if it wishes to make such a report public.

The FRC considers that the legislative requirements can be satisfied by a combination of some or all of:

(i) the paper prepared for the Audit Committee to support its deliberations and recommendation to the Board for appointment;

(ii) the Board paper which sets out the Audit Committee’s assessment and recommendations; and

(iii) material contained in the annual report of the Audit Committee in the company’s annual report, as that will set out the main areas of focus of the Audit Committee during the year being reported upon.

Feedback
Providing audit firms with good feedback on the reasons for the decision made is vital for the improvement of the tendering process in the audit market.

Our discussions with audit firm representatives indicated that firms often feel that they are not receiving comprehensive feedback on the reasons for an unsuccessful proposal.

It often feels like the real reason for the decision is not given. It would be helpful to get honest feedback.

Audit firm representative

Audit Committees should be prepared to give comprehensive feedback to the firms on the reasons for the decision made.

Fees
Audit Committees should conduct the fee negotiation, rather than management.

The limited evidence (from FRC analysis to date on audit fees) following a change in
auditor, indicates that there is no significant downward pressure on fees as a result of the tendering process.

"Investors worry if audit fee is low compared to peer companies."

Investor representative

In talking to Audit Committee Chairs, it was clear that audit fee levels are not a major consideration in the decision process. Fee proposals were often fairly similar across all firms.

Some Audit Committees have undertaken the tendering process on a “fee blind” basis, where the audit fee is negotiated after the decision on which firm to appoint. The FRC’s engagement with investors identified mixed views on this approach, with some indicating that, in their view, audit fees were de-minimis, but other investors being more conscious of cost as an important factor.

Audit Committees should seek views on audit fees in their engagement with major investors regarding the tender process.

The legislation requires the outgoing auditors to share all relevant information with the new audit team. This includes the reporting on the most recent audit from the auditor to the Audit Committee.

Shadowing during a final year audit can be a useful way of ensuring that the new audit firm gets up-to-speed, but should not be used to ensure the firms concur on audit judgements.

The transition period should also be used to ensure that the incoming firm complies with the relevant independence requirements.

Companies have been nervous about transition, but Audit Committee Chairs experience has shown that the new audit team often brings a welcome set of fresh eyes. Companies need to be realistic about the demands on management of the first year of a new auditor, and the associated cost.

Audit Committees should consider whether their priorities in transition are a smooth, efficient transition, an opportunity to “kick the tyres” or a combination of the two.

Audit quality is most likely to be improved by a robust, kicking the tyres, approach to transition, which could include a root and branch review of accounting policies.

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Transition

“Transition has been quite tough – there is so much learning for the new team. However, we now have a better quality audit and the Board has learnt a lot.”

Audit Committee Chair

“Having sufficient lead time is key in managing transition risk”

Audit Committee Chair