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Reviewing or Tendering your External Audit

The Corporate Governance Considerations

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Contents

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Introduction: the UK Framework

The Enron scandal in 2001 combined with similar scandals at Worldcom and Global Crossing and the subsequent collapse of Arthur Andersen, one of the 'Big 5' firms of auditors at the time, has led regulators around in the world to tighten rules around the appointment of external auditors and how audits should be performed. In the UK, which had gone through a series of scandals, which included names such as Polly Peck, Robert Maxwell and BCCI, a decade earlier, the remedy has been shoe-horned into the Corporate Governance framework which emerged.

A short history of UK Corporate Governance is helpful in setting the context for the relationship between a company and its auditor. In 1990 the Government announced the establishment of The Financial Reporting Council ("FRC") which in 2004 became the single independent regulator of the accounting and auditing profession, operating through bodies including the Accounting Standards Board, Auditing Practices Board and the Financial Reporting Review Panel.

The FRC is now the guardian of the UK Governance Code ("the Code") which first emerged from the Cadbury Report in 1992. Cadbury codified the role in UK companies of audit committees, which had been common in US companies – the New York Stock Exchange had required their listed companies to have audit committees since 1978. The Cadbury report gave an interesting justification for audit committees which is as true now as it was then, that "They offer added assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests."

In 2003 the report of the FRC-appointed group chaired by Sir Robert Smith was published which contained the "Smith Guidance" on audit committees. This was updated in 2005, 2010 and 2012 and is intended to assist company boards when implementing the sections of the Code dealing with audit committees and to assist directors serving on audit committees in carrying out their role.

Current Companies Acts Requirements

Under the UK Companies Acts, the auditors of listed companies are appointed by resolution of shareholders at each Annual General Meeting and can be removed by shareholder resolution. In practice, the directors will propose the resolutions to be considered by shareholders and are therefore responsible for proposing who the auditors are and managing the relationship with them. Providing safeguards over how the directors exercise their de facto powers of appointment is left to the Code.

Current European and Listing Rule Requirements

The 2006 Audit Directive, which applies throughout the EU, was designed to enhance the accuracy of statutory accounts in response to a number of European scandals such as Parmalat in Italy and Ahold in the Netherlands. It was broadly transcribed into UK law though the Disclosure and Transparency Rules ("DTR") found in the FSA's listing rules and which therefore apply to all listed companies.

The DTR require companies to set up audit committees and contain minimum terms of reference for those committees, including a requirement that the company must "base any proposal to appoint an auditor on a recommendation made by the Audit Committee". In the UK, the Code requirements which are covered below go further than the DTR. However, compliance with the Code is on a "comply or explain" basis, so that companies may opt out of the requirements where they can justify the omission to their shareholders. Compliance with the DTR is compulsory and is policed by the FSA acting as the UK Listing Authority.

Current Code Requirements

The Code applies to all Companies with a Premium (formerly called a primary) Listing on the London Stock Exchange. It does not therefore apply to those whose main listing is on another Stock Exchange or to AIM-listed companies. However, the Code was always designed to be a best practice guide and Aim-listed or large private companies as well as other non-business organisations regularly look to the Code for guidance on best practice.

The current Code requires a company to have an audit committee made up of non-executive directors (Code provision C.3.1). The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of external auditors. This recommendation should be made to the board for it to put to shareholders at the Annual General Meeting.

This is supplemented by Guidance on Audit Committees issued by the FRC in September 2012 (the "Guidance"). The introduction to the Guidance notes that whilst it is not compulsory, it is intended to assist Boards when implementing the relevant Code provisions. The Guidance clarifies the Code requirement more bluntly when it says that "the audit committee is the body responsible for overseeing the company's relations with the external auditor."

The Guidance notes that Companies must provide the necessary resources available to audit committees to undertake its duties. In particular, the issue of resources for the audit committee is covered: "The board should make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so." This could include the provision of consultancy advice to assist with review or tender.

Reporting to shareholders

The annual report should contain a separate section to describe the work of the audit committee (Code provision C.3.8). As regards the auditors, this should explain to shareholders how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditors. This explanation should include supporting information on the tenure of the current audit firm, when a tender was last conducted and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

Appointment, Reappointment and Removal of Auditors

The Guidance gives useful advice to Audit Committees on how the recommendation to the Board should be made. It should be based on annual assessments of:

- → the qualification,
- → expertise and resources, and
- → independence and objectivity, taking into consideration relevant UK professional and regulatory requirements
- → of the external auditors and the effectiveness of the audit process.

If the external auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

Therefore at the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process. In the course of doing so, the audit committee should:

- → review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
- → consider the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, and in their commentary where appropriate on the systems of internal control;
- → obtain feedback about the conduct of the audit from key people involved, e.g. the finance director and the head of internal audit; and
- → review and monitor the content of the external auditor's management letter, in order to assess whether it is based on a good understanding of the company's business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.

In order to address the concentration of the audit market in the hands of the "Big 4", the Guidance suggests that the audit committee should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning. However, it is not clear how this should be done.

Engagement of auditors

The Guidance makes it clear that if the audit committee recommends considering the selection of possible new appointees as external auditors, it (and not the company's management) should oversee the selection process.

The audit committee should approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided. The audit committee should review and agree the engagement letter issued by the external auditor at the start of each audit, ensuring that it has been updated to reflect changes in circumstances arising since the previous year.

On the subject of audit fees, the Guidance suggests that the audit committee should be sceptical about auditors "low-balling" their fees and satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective high quality audit can be conducted for such a fee.

Audit tendering for FTSE 350 Companies

The Code has, for accounting periods beginning on or after 1st October 2012, a provision (C3.7) that FTSE 350 companies should put their external audit contract out to tender at least every 10 years.

The guidance makes it clear that the provision for FTSE350 companies to tender their audits is not the same as mandatory audit rotation i.e. the incumbent could be reappointed following a tender process. The tender process enables the audit committee to compare the quality and effectiveness of the services provided by the incumbent auditor with those of other audit firms.

There is limited guidance on how to undertake an effective tendering process. However, companies should allow shareholders to provide input to the process should they wish and the company should announce its intention in advance of the commencement of the tendering process.

Transitional arrangements

The FRC recognised that the introduction of regular tendering for the external audit contract, even on a "comply or explain" basis, would need to be carefully managed. If all those companies that have not gone out to tender in the last ten years were to do so in the first year following the change to the Code the market would struggle to cope.

Therefore, the Code requirements on audit tendering are only applicable to FTSE350 companies "in the first instance". There is a clear implication that regular tendering should become best practice and the requirements may, in future, be extended to smaller companies subject to the Code.

The transitional arrangements are not intended to be binding arrangements and are therefore not incorporated either in the Code of the Guidance, but are set out on the FRC's website[1]. The FRC has made it clear that: "companies should put the audit contract out to tender earlier than they would be expected to under these arrangements if they feel it is appropriate to do so, and shareholders should feel free to request them to do so. Equally, as with all other provisions of the Code, companies can choose not to comply and explain why not. Whatever their decision, the FRC would encourage companies to state when they first report against the 2012 Code whether or not they anticipate putting the audit contract out to tender in due course."

[1] http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx

The suggested timing of a tender is linked to two criteria:

- → when the current audit engagement partner is due to rotate; and
- → the length of time since the audit contract was previously tendered.

It is suggested that where a company has put the audit contract out to tender or changed audit firm in or after 2000, the tender process might be deferred until the latter stages of the incoming audit engagement partner's term. In other words, for a further five years.

Example: if the current audit partner was due to complete their five year period in 2014 the company would carry out a tender in time for the successful audit firm (which could be the incumbent firm) to take up their appointment when that partner steps down. However if the company had carried out a tender or changed audit firm more recently than 2000, this could be deferred until the next partner rotation in 2019.

Effect of transitional arrangements for companies who have not tendered in 2000 or after:

Next partner rotation for accounting year ending	Year due to tender		Notes
	Have not tendered since 1999	Have tendered since 1999	
On or before 30th September 2013	2018	2018	Revisions applicable to accounting periods beginning after 1st October 2012
31st December 2013	2013	2018	
31st December 2014	2014	2019	

During the year

The scope of the external audit should be reviewed by the audit committee with the auditor. If the audit committee is not satisfied as to its adequacy it should arrange for additional work to be undertaken.

Auditor Independence

The audit committee should assess the independence and objectivity of the external auditor annually, taking into consideration relevant UK law, regulation and professional requirements. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services) and any safeguards established by the external auditor. The audit committee should consider whether, taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor's independence and objectivity.

The audit committee should seek reassurance that the auditors and their staff have no financial, business, employment or family and other personal relationship with the company which could adversely affect the auditor's independence and objectivity, taking account of relevant Ethical Standards. The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff. Most audit firms of any size publish their independence policies, often on their web-sites.

The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor, and keep the policy under review. It is now standard practice for a written policy on the provision of non-audit services to be put in place and a number of such policies are available on companies' web-sites. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In this context, the audit committee should consider:

- whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service;
- whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
- the nature of the non-audit services;
- the fees incurred, or to be incurred, for non-audit services both for individual services and in aggregate, relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

Accountancy Bodies requirements for auditors

The regulator of the auditing firms, the Auditing Practices Board ("APB"), has published guidance to audit firms to identify and assess the circumstances which could adversely affect the auditor's objectivity , including any perceived loss of independence, and to apply procedures to eliminate or reduce that threat to an acceptable level. It is felt that "self-interest, self-review and familiarity threats" to the independence of the audit may arise.

The APB suggests a number of safeguards which can address this threat, including:

- → partner rotation
- → involvement of an additional partner
- → applying independent internal quality reviews to the audit in question.

Partner rotation

The audit committee should monitor the external audit firm's compliance with APB Ethical Standards for Auditors relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, or relevant part of it[6], and other related regulatory requirements. The overall fee income of all sizeable audit firms is published in annual surveys by a number of accountancy magazines as well as in an annual study of "Key Facts and Trends in the Accountancy Profession" by the Professional oversight Board, part of the FRC.

A degree of flexibility over the timing of rotation of the audit engagement partner is possible where the audit committee decides that it is necessary to safeguard the quality of the audit. In such circumstances, the audit engagement partner may continue in this position for an additional period of up to two years, so that no longer than seven years in total is spent in this position. The audit committee should disclose this fact and the reasons for it to the shareholders as early as practicable.

Use of Joint Auditors

The use of firms from more than one audit network is more common in a number of European countries than it has been historically in the UK. The company appoints two firms who are expected to reach a single group audit opinion for which they are jointly responsible. Audit work that is needed for group audit purposes would normally be carried out by firms from the joint auditors' networks.

Guidance
Guidance from the ICAEW sets out a number of circumstances when the appointment of joint auditors may find this arrangement useful :

- where two groups have completed a merger and wish to maintain audit experience and knowledge by keeping the auditors involved in each of the merged entities;
- where a company wishes to have the benefits of an audit opinion from two firms;
- to reduce the scope for close relationships to build up with the auditor or for the auditor to become complacent;
- to facilitate the rotation of audit firms by maintaining audit knowledge and experience;
- to have a safeguard against the withdrawal from the market of their auditor.

Fees for joint auditors are invariably more than for a single audit firm.

Appointing other audit firms to subsidiaries
The Guidance suggests that audit committees may want to consider whether there might be any benefit in using firms from more than one audit network and guidance on the considerations relevant can be found on the FRC website. A number of FTSE 350 companies have gone down this route fairly recently and have appointed another firm, typically from outside the "Big 4" to subsidiaries. This can reduce the overall audit costs, whilst maintaining an audit opinion from a "Big 4" firm at parent company and group level.

Conclusion: Have companies complied with the Code?

As can be seen, the UK requirements for audit committees are now onerous and there is extensive guidance available on best practice. Given that the main work of the audit committee is to oversee the audit and production of accounts, which for a FTSE 100 company may now run to several hundred pages, it would not be particularly surprising if the amount of time left to assess the efficacy of the audit process and make a reasoned recommendation as to the reappointment or otherwise of the auditors took a back seat.

Several quantitative and qualitative studies have backed this up. Grant Thornton produce an annual Corporate Governance Review of the FTSE 350, the 350 largest companies listed on the London Stock Exchange. Its 2011 Review found that 34% of companies gave no disclosures on the decision to appoint, reappoint or remove their auditors, whilst only 17% provide a full explanation with the remainder providing only basic information. Whilst these figures were an improvement on the 2010 survey, Grant Thornton noted that the disclosures were introduced by the FRC in 2008. They also noted that in 2011, 83% of the FTSE 350 did not disclose when they last held an audit tender, perhaps suggesting that tenders are still rare.

A 2011 ICAEW Report subtitled “An analysis of audit committee reporting” noted that the quality of reporting was better in the FTSE 100, but that less than 60% of FTSE250 companies referred in audit committee reports to a review of the effectiveness of external auditors and this dropped to 30% in the FTSE All Share (ex-350).

In our experience, the quality of audit effectiveness reviews varies dramatically, from companies which have not carried out the minimum recommendation to assess audit effectiveness, through companies where the finance function prepares a short paper for the audit committee on “how the audit has gone”, though to a very small number where the is an objective assessment of the effectiveness of the audit process and a reasoned recommendation to reappoint the auditors. In particular, we find that the Guidance recommendation to consider the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, particularly difficult for the finance function to answer. The changes made to the Guidance by the FRC in September 2012 are designed to pressurise audit committees to spend more time on this area. In our opinion, audit committees would benefit greatly from an objective third party carrying out such reviews.

Future regulatory developments

Politicians and regulators from the World Bank, the EU and the UK are looking seriously at changing some of the requirements. These developments will at least continue the emphasis being placed on the external audit process and the firms that provide audits to “public interest entities”. They may go further and provide a legal and/or regulatory external stimulus to external audit provision and may result in increased tendering and rotation of audits.

There is concern that the market for top company audits is now dangerously concentrated and does not represent a competitive market and external stimulus may be needed to enhance competition in audit services. As a result of the collapse of Arthur Andersen following the Enron scandal, the external audits of the largest companies worldwide has been dominated by “The Big 4”: PWC, Deloitte, Ernst & Young and KPMG. In the UK just seven firms audit all the FTSE 350. BDO, Grant Thornton and PKF have just 13 audits with only one company in the FTSE 100 using them.

There are 2 further developments which individually or in combination may change the governance arrangements for external audits:

1. The OFT has referred the auditing sector in the UK to the competition commission, which could recommend remedies to Government or, possibly, enforce remedies directly onto the largest auditing firms.

2. The EU Single Market Commissioner has a remit to promote competition in the EU. He first produced a Green Paper on Auditing in October 2010, but in November 2011 refined its proposal to "address the current weaknesses in the EU audit market, by eliminating conflicts of interest, ensuring independence and robust supervision and by facilitating more diversity in what is an overly concentrated market, especially at the top-end." Under the proposal "Public Interest Entities" (PIE), which include all banks, insurance companies and listed companies (AIM is excluded) would be required to rotate their auditors every 6 years, with a cooling off period of 4 years before the same firm could be reengaged. In addition PIEs "will be obliged to have an open and transparent tender procedure when selecting a new auditor. The audit committee (of the audited entity) should be closely involved in the selection procedure." These proposals are in the course of being reviewed by the European Parliament, which appears to be minded to increase the number of years before auditor rotation.

It is interesting to note that mandatory firm rotation is also being looked at in the US. The Public Company Accounting Oversight Board (PCAOB) issued a "Concept Release" on this subject in August 2011 and held a public roundtable discussion on the issues in March and June 2012. It is thought that the PCAOB's attention is now also moving towards compulsory tendering rather than mandatory firm rotation.

Further Reading

Guidance on Audit Committees *The Financial Reporting Council December 2010*

http://www.frc.org.uk/images/uploaded/documents/Guidance%20on%20Audit%20Committees%202010%20final1.pdf

Evaluating your auditors, Guidance for audit Committees *The Institute of Chartered Accountants of England & Wales November 2003*

http://www.icaew.com/~/media/Files/technical/Audit-and-assurance/audit/guidance-for-audit-committees/evaluating-your-auditors

Appraising your auditors: A Guide to the Assessment and Appointment of Auditors *The Institute of Chartered Accountants of Scotland 2nd Edn October 2007*

http://icas.org.uk/home/technical-and-research/technical-information-and-guidance/auditing/appraising-your-auditors/

Long Association with the Audit Engagement *The Auditing Practices Board October 2009*

http://www.frc.org.uk/apb/publications/pub2121.html

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David trained as a Chartered Accountant at the London office of Arthur Andersen (now Deloitte). Following a spell in investment banking, he became finance director of a London Stock Exchange premium -listed company. In this latter role he was a major user of the audit services and non-audit services of a "Big 4" firm as well as having oversight of internal audit. He combines his role at Audit Review with a number of non-executive directorships and is chairman of the audit committees of two sizeable insurance companies.

David is a Fellow of The Institute of Chartered Accountants in England & Wales and an Associate of the Chartered Institute of Taxation. He is deputy chairman of the ICAEW's NED Group, for whom he regularly lectures on corporate governance issues.