



## **THE AUDIT TENDERING PROCESS**

### **THE EXPECTATIONS OF UK INSTITUTIONAL INVESTORS**

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#### **Introduction**

This paper has been prepared by the Institutional Investor Committee (IIC), which comprises the main trade associations that represent institutional investors in the UK, and sets out guidance for audit committees when companies tender their audits and on audit firms' transparency when they no longer hold office. Background to the IIC and contact details are set out in the attached Annex.

One of the concerns investors have is that where audit firms hold office for long periods this can impact their independence and objectivity, both of which are vital in ensuring audit quality. Investors consider that reduction in average tenure is a well-founded public policy objective and one that audit committees on behalf of shareholders/investors should seek to achieve.

There have been various recent initiatives that seek to address this, both from the European Commission and the UK's Competition Commission. These have included measures to introduce mandatory audit firm rotation and requirements to tender the audit periodically. The UK market appears to be responding to these in that audits are now being tendered more frequently. This is welcomed.

The aim of this paper is to set out guidance for audit committees when companies tender their audits and covers, inter alia: (1) transparency when companies decide to tender; (2) identification of candidates to be invited to tender; (3) the tender process, including consultation with institutional investors on the objectives and selection criteria; and (4) audit firms' transparency when they cease to hold office.

### 1 Transparency when companies decide to tender

Auditors essentially act as independent scrutineers of management's reports for the company's shareholders. Thus when a company undertakes an audit tender it should be done for and on behalf of investors' interests— providing a strong measure of accountability.

- **Companies should disclose an audit re-tendering policy in the Audit Committee report in the annual report and specify when they intend to next tender the audit.**

Companies should endeavour to disclose their intention to tender a year or more ahead of the process. As companies adapt to the new limits on length of audit tenures Audit Committees ought to be able to plan ahead adequately. Giving sufficient advance notice will give institutional investors the opportunity, should they wish to do so, to be consulted on the envisaged tender process.

### 2 Identification of candidates to be invited to tender

It is the company's decision which audit firms it should invite to be part of the tender process. In forming this decision, a company is likely to consider an audit firm's geographical scope, reputation, and knowledge of the particular industry or sector.

For investors what is important is that an audit firm is independent and objective and thus able to deliver a high quality service. When considering potential candidates, investors wish to see the company consider whether the firm is providing non-audit services or if any of the company's senior employees/ directors were previously employed by the firm, particularly if this was in a senior capacity, such that independence and objectivity are impacted.

- **To ensure independence, the level of non-audit services provided by an audit firm should be considered and, in normal circumstances, at least three years should have elapsed from when a company director was employed by an audit firm before the firm is considered for appointment.**

The three year expectation may be longer where the individual will be closely involved in the future audit relationship and/or formerly had a direct relationship with the company when at the audit firm. However, it may be appropriate to consider an audit firm where the Director sits on the Audit Committee and the conflicted individual absents his or herself from the process. However, in such circumstances it will be important for the Audit Committee to explain how they have safeguarded the independence of the process.

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The Competition Commission's report on the provision of statutory audit services<sup>1</sup> noted that the overwhelming majority of audits in the FTSE 350 are undertaken by one of the four largest accounting firms: Deloitte LLP; EY LLP; KPMG LLP; and Price Waterhouse Coopers LLP. This is unfortunate as investors are keen to see a vibrant audit market.

- **Investors would expect in most cases a wide range of audit firms to be invited to tender including those from outside the four largest accounting firms, with a genuine prospect that they may win the work.**

Investors do not support clauses in agreements that restrict a company's choice of auditor, instead investors support a prohibition on provisions in loan agreements which restrict or have the effect of restricting a company's choice of auditor to lists or categories.

### **3 The tender process, including consultation with institutional investors on the objectives and selection criteria**

For the tender process to be successful and focussed, a company should set clear objectives as to what it wants to achieve and what it is looking for in a potential auditor.

- **A company should consider contacting its major investors early in the process in order that they are given the opportunity to be consulted on the proposed process: for example, on how the Audit Committee intends to assess audit quality, the success criteria that will be applied and how the outcomes will be concluded.**
- **The tender process itself should be managed by the Audit Committee and its chairman.**

Whilst various aspects of the tender process may necessitate the involvement of operations and finance functions, in the interests of ensuring it is objective, the ultimate responsibility for the process should belong to the audit committee. For the same reason, it should be the audit committee that makes the final recommendation to the board as to the preferred firm. The board should seek out the views of the company's major investors before making the appointment.

The audit committee should ensure that in making its recommendation it puts audit quality and not price as its main criterion. The main consideration for investors is that the auditor that will provide the highest quality audit is selected and prospective auditors should demonstrate clearly that they can provide a quality service.

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<sup>1</sup> [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/131016\\_final\\_report.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/131016_final_report.pdf)

### 4 Audit firms' transparency when they cease to hold office

If a company decides to appoint a new auditor there are two ways that the existing auditor can cease to hold office, either by removal under a formal resolution, or by resignation. In each case, auditors have the right to make a statement about their departure from office and the company should facilitate this being published to shareholders.

- **Institutional investors expect that, where appropriate, auditors exercise these rights fully and clearly.**

Companies have the right to bar such disclosures if they can demonstrate to a court that the powers are being used to 'secure needless publicity for defamatory matter'. Investors would be concerned if a company used the law and made a court application to delay the publication of a statement so they do not become aware of the relevant 'circumstances' until much later.

- **A court application in connection with an auditors' removal or resignation should not be unnecessarily prolonged or pursued simply to delay providing information to shareholders that might be critical of the company.**

In this context, it would be helpful if the FCA made it known that, if a company makes an ill-founded application to the court as a way of delaying the publication of price sensitive information related to the auditor ceasing to hold office, it would consider taking action for a breach of the issuer's obligations to make timely disclosure.

Investors are also concerned that particularly when auditors resign they may not always be providing information about the 'circumstances'. Whether this is because there is no relevant information to impart, a desire to avoid saying anything critical about a former client or a genuine concern that, by doing so, the auditors could expose themselves to liability is difficult to assess.

To improve the transparency in this area the ICAEW should consider developing guidance to ensure that auditors fully understand their responsibilities under the law.

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## THE INSTITUTIONAL INVESTOR COMMITTEE AND CONTACT DETAILS

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The IIC is made up of representatives from the Association of British Insurers (ABI), the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF). The ABI represents the UK's insurance, investment and long-term savings industry. IMA represents the asset management industry operating in the UK. Its members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. The National Association of Pension Funds is the voice of workplace pensions in the UK and represents 1,300 pension schemes with some 16 million members.

The members of these associations together manage/own over £4 trillion of assets, which are invested globally, and are major investors in companies whose securities are traded on regulated markets.

The IIC would be pleased to engage further on this subject. Contacts are:

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