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Sir John Kingman
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9th November 2018

Dear Sir John,

Thank you for your recent letter asking for comments and suggestions about arrangements for auditor procurement and remuneration. We believe that this is a highly relevant line of enquiry and we welcome it as an extension to the terms of reference of your review.

We have responded to the Competition and Markets Authority's (CMA) consultation and made similar comments to them about our views on audit procurement practices. We would be pleased to discuss any of our comments and suggestions with you in more detail if this would be helpful.

1. Summary of Recommendations

Recent financial reporting scandals suggest that standards of quality for external audit services are very variable. Linked to this is a growing perception that the audit often fails to meet the needs and expectations of shareholders. Wider choice and more competition in the audit market would be beneficial, but competition does not necessarily lead to improved quality. We believe that a fundamental problem is the way in which audit services are currently procured. We recommend that:

- The Regulator (the FRC) should work with preparers and users of financial reports to develop model specifications for audit services which are fit for purpose in relation to current accounting standards.
- The Regulator should investigate the scope to divide the audit service specification into lots, particularly for FTSE 100 companies. Bidders would then be able to bid for all or any of the lots making it possible for the audit to be split between firms and for smaller firms to bid for individual lots.
- The rules governing purchases of service contracts by non-central government contracting authorities (i.e. contracts over £181,302) should be applied in modified form to the purchase of audit contracts. The modified rules should aim to ensure good procurement practice and transparency. Their adoption should be a legal requirement for audit purchases by FTSE 350 companies.

- There should be standard contractual terms and conditions for audit contracts. Companies may vary these to meet their own and their shareholders specific circumstances but in all cases they should be written to protect the interests of the customer (in this case, the shareholders) as in any other procurement situation. For small, privately owned businesses these rules would not apply.
- There should be a stakeholder group within each company which should be involved with the audit committee in the procurement of the audit contract. Both the audit committee and the stakeholder group should receive appropriate training as and when required.
- Training should be provided either by the appropriate Regulator or accredited training providers. Accreditation should be by the government or Regulator working in conjunction with the Chartered Institute of Purchasing and Supply (CIPS).
- The Regulator or a similar body should carry out a review of a sample of audit procurements each year to ensure that the process is rigorous and is performed in a spirit of open and fair competition and with a view to the achievement best value for money rather than lowest cost.
- The members of the stakeholder group should meet formally on at least a six-monthly basis with the audit committee and informally as required to allow stakeholder oversight of the work of the external auditor.
- Stakeholder groups should have the opportunity to review and comment on the work of the internal audit team.
- FTSE 100 companies should be given encouragement to implement 'reverse marketing' programmes to encourage mid-tier and smaller audit practices to acquire the necessary breadth of resource and experience to carry out audits for them. Dividing the audit contract into lots, as suggested above, could help in this respect.
- Firms providing audit services to large companies and public interest enterprises (PIEs) should not be allowed to sell consultancy services.

We do not believe that there is any need to involve a government-sponsored third party in the appointment of auditors – other than the Regulator, as we have suggested below. There is more than enough scope to improve the current lax and deficient approaches to procuring audit services without resorting to solutions that could undermine the principle of shareholder primacy.

Our recommendations are discussed in more detail below.

2. Good procurement practice

2.1 The procurement process

The procurement of audit services has traditionally been woefully inadequate. It is only recently, thanks to EU legislation, that there has even been a requirement for the purchase of audit services to be tendered at least once every ten years and for the contract to be rotated at least every twenty years. The external audit is a critical service upon which investors and other stakeholders depend for reassurance that the financial statements provide a true and fair account of the company's financial performance and viability. The way in which audit is currently procured does not reflect its importance. There is also more to good procurement than

simply doing a good deal; the ensuing contract has to be properly managed. Again, in the case of external audit, current attitudes and approaches by many companies are deficient. This has to change.

The problem with the procurement process

The current tendering and rotation periods are too long. In the public sector which is governed by good-practice principles, only the largest and most complex service contracts involving significant investment by the supplier would run for periods of ten years. A contract for four years with the scope to extend for up to a further two years is more normal.

The procurement of the audit contract has typically by-passed the purchasing professionals in most UK listed companies. It has always been handled by the audit committee and / or a few senior members of the management team. In most cases, these individuals have no procurement training or experience; in the case of senior managers they may also be conflicted. It is not clear how well the audit specification is drafted, whether the evaluation criteria are communicated to suppliers before they bid and how robust and impartial the whole evaluation process is. There is no scope for suppliers or shareholders to challenge the final decision on auditor selection even if there is evidence to suggest that it was unclear or unfair.

The whole process is opaque to shareholders and other stakeholders. There is usually little meaningful information and feedback in the annual report on the process.

The solution

The procurement process should demonstrably provide fit-for-purpose audit services at a price which represents value-for-money.

Specific comments about the tendering and selection process for audit services are discussed below in Section 2.3. However, for meaningful change to take place, firm action is required. We suggest that:

- The maximum period for audit contracts should be seven years with a requirement that no auditor should be able to serve for more than two consecutive terms
- As in public sector procurement, audit contracts should be openly advertised. The Regulator (the FRC) should be required to set up an electronic advertising system on which FTSE 350 companies would advertise their audit requirements. The basic operational principles would be similar to those of the Official Journal of the European Union (OJEU) in that companies would be required to issue a Prior Indicative Notice of their intention to retender their audit contract at least three months (in this case) prior to issuing a formal 'call for competition.' The official website for advertising audit contracts should be accessible to any interested bidder anywhere in the world.
- There should be prescribed minimum timescales for prospective bidders to respond to the call for competition; this would ensure that all bidders were given adequate time to prepare and submit bids.
- Following a decision on the award of the contract, there should be a standstill period. Bidders who felt they had been unfairly treated should be able to challenge the award decision. Challenges would be reviewed by the Regulator who would decide whether any challenge should be upheld.

- The contract award decision should be publicised on the website within three weeks of contract award.
- All bidders should have the right to a formal de-brief if they so request.

The Regulator should carry out a review of a sample of audit procurements each year. A review of, say, five procurements should be adequate. The Regulator should have the power to order a rebid if there was evidence that due process had not been followed. This would also be the outcome of a successful challenge by a bidder.

2.2 Setting the specification

The specification for any product or service should be based on a full assessment of stakeholder needs. In the case of external audit, stakeholders are likely to include:

- investors (institutional and private)
- customers (who want to be sure that key suppliers will be able to deliver on contractual commitments)
- suppliers (who want to be sure they will get paid)
- employees (who want to be sure that their jobs are not at risk due to the financial mismanagement of the company or deceit)
- the company's directors (who want an independent check that, for example, fraud is not taking place).

There may be others, depending on the company and its activities.

Some of these stakeholders are more important than others. The shareholders are a key stakeholder group and the primacy of shareholders is recognised in CA2006, S172. The audit is primarily for their benefit and they are ultimately the ones who pay for the audit. It is vital that their needs and expectations are met. The directors of the company are relatively minor stakeholders who act as the buyers of the audit on behalf of the other stakeholders.

<u>The problem with the audit specification process</u>

The problems with the system at present are that:

- The key stakeholders, particularly the investors, make almost no input to the specification for audit servicers. It is not clear to most investors whether a satisfactory specification is issued to bidders for audit services. It is likely that very few investors have ever seen a specification for audit services and that even fewer have been asked to comment on it or to agree whether it meets their needs. This is a crucial issue. If the specification is wrong (or deficient in any way) the service purchased will not meet the needs and expectations of the key users. Money will be wasted buying a service that is not fit for purpose. In the worst cases it will positively unhelpful.
- Senior management have a much more limited role to play as stakeholders. They have (or should have) an interest in the audit as an external check on the company's own financial control and management systems. However, both management and auditors are potentially conflicted. . Under *current* accounting rules there are often

incentives for directors to influence valuations and judgements by the auditor which will affect management bonuses. Incentives to audit partners to retain audit business may make them inclined to agree with management.

There is almost certainly scope to improve the systems for drafting the audit specification so as to ensure that it is fit for purpose and so that the supplier and the customer know exactly what is to be provided. Good specifications help to ensure appropriate competition and the achievement of value for money.

The solution

In order to avoid a situation in which every company wastes time developing an audit specification from scratch, and with varying degrees of success, the Regulator should at the first opportunity set up a special project to:

- Define key requirements for a fit-for-purpose audit service
- Provide written guidance on developing an audit specification
- Provide one or more model specifications with optional variations

Companies would not have to adhere rigidly to the model/s. They should be able to amend them to meet their own specific needs.

In developing the standard specification, consideration should be given to how it could be divided into lots (a common approach with public sector framework agreements). Suppliers would be able to bid for all or any of the lots. This would have the benefit of allowing smaller firms or firms with specific skills and capabilities to bid for individual lots. In cases in which lots were awarded to different suppliers, one firm would have to act as the 'lead' auditor with overall responsibility for signing off the audit. This could create an additional layer of complexity but making it work should not be an insuperable task.

There has to be an effective system for allowing key stakeholders to contribute to the audit specification. One way of doing this would be for each company to appoint a stakeholder group which would work with the members of the audit committee to agree the audit specification. As outlined above, this need not be particularly onerous if a standard, sample specifications for audit services could be developed which individual companies and their stakeholders could adapt to their own specific needs.

It is likely that this process would benefit initially from specialist external advice and guidance, possibly from the Regulator (currently the FRC), to ensure that:

- Members of the stakeholder groups were appropriately briefed on their responsibilities and given whatever training was necessary (as for, for example, is the case with pension fund trustees).
- Measures were implemented to ensure that the stakeholder group could not be 'captured' or disrupted by extremist single-issue or special interest groups.

Expert procurement input from the company's own procurement specialists should be encouraged and expected. In some cases further guidance from The Chartered Institute of Purchasing and Supply (CIPS) might be beneficial. This should be accessed via the Regulator.

2.3 The tendering and evaluation process for audit services

The problem

The way in which the tendering and evaluation process for audit services currently works often appears opaque. It seems that it is usually carried out by members of the audit committee with input from senior management. It is also unclear:

- How the evaluation criteria were set and agreed and how they were 'weighted';
- Whether they reflected the true needs and expectations of the key stakeholders;
- Whether the whole evaluation process was as thorough as it could be, was properly documented and open to scrutiny.

The solution

Part of the initial project by the Regulator to provide model specifications would include providing guidance on the tender evaluation process. It should be possible to provide examples of appropriate evaluation criteria and the use of weightings to prioritise them. Audit is not such a varied process that the key evaluation criteria are likely to vary significantly from one customer to another. Training for those responsible for chairing or moderating the tender evaluation process and for those responsible for scoring bids should also be offered.

The bid-evaluation panel should include two or three members of the stakeholder group as well as members of the audit committee. It should normally be moderated and administered by a procurement professional from within the client company. There should be a report on the process in the annual report and accounts which should go well beyond the current sketchy summary contained in the report of the audit committee. The process should also be reported on at the AGM. As re-tendering is only likely to happen once every six or seven years this should not be onerous.

2.4 Contract management and supplier relationship management

The problem

Currently the audit committee appears to have responsibility for the management of the external audit contract. We say 'appears' because in most annual reports the commentary on the work of the external auditor is contained within the audit committee report. However, there is no statement of what constitutes best practice in this area and there are concerns about the scope for senior executive managers to apply undue influence to the deliberations of and any recommendations by the auditor.

In most cases the report on the external audit and the specific issues addressed is superficial and vague. Shareholders are told that the auditors identified key risks for audit consideration. However, they are not told why these were considered to be key risks. Nor are shareholders told what the outcome of the auditor's work was – apart from reassurances that everything was alright. All too often it appears that the so-called audit plan was devised so as to put a tick in series of check-list boxes by the auditor regardless of whether they were really relevant to recent developments within the business. In the case of Persimmon PLC, the audit committee report states:

'The Committee ensures that the auditor has exercised due professional scepticism. The Committee has reviewed and is satisfied with the performance of Ernst and Young plc'.

Nothing could be less enlightening for shareholders – and this in relation to a critical service for which shareholders paid £169,000 plus a further £46,000 for non-audit work. The exact nature of the non-audit work is not specified.

A further area of opacity involves the early termination of an audit contract by either side. Currently there is no requirement to for the company or the auditor to say why the contract has been terminated. If an auditor resigns the audit or is dismissed by the company the shareholders must be told why.

Finally, the way in which the audit contract is governed in law is highly unsatisfactory. The audit, as discussed above, is primarily for the benefit of the shareholders. However, the audit contract is actually between the auditor and the client company. The company may have little interest in ensuring that the contract with the auditor is appropriately tough in promoting and protecting the interests of the shareholders. The case of Caparo Industries plc V Dickman (1990) demonstrates how difficult it is for shareholders to take legal action against an auditor who has clearly performed negligently.

Legal action is nearly always costly, protracted and uncertain. It should always be a last resort. A better course of action would be for the Regulator to intervene on behalf of the shareholders in taking auditors to task over issues such as negligence, misconduct and failings of duty of care. Instead, we have a situation in which the FRC is allowed two years (with no sanctions if this is exceeded) to review cases of misconduct and in which all too often the conclusion is that, as no rules were broken, there is no case to answer. This is unacceptable.

<u>The solution</u>

Just as there should be model specifications for audit, so there should be standard contract terms and conditions which ensure that auditors really can be held to account by shareholders. The contract terms should be appropriately tough and should be drafted to favour the user - i.e. the shareholders. This would be the normal approach in any other procurement situation. Legalistic caveats, such as the claim that the auditor is only providing 'an opinion', should not be allowed to get in the way of the fact that the auditor has a duty of care to the shareholders. Some issues, such as the valuation of intangible assets may be a matter of opinion and judgement. Others, such as the amount of cash in the business, bank overdrafts and current tax demands from HMRC should be matters of fact.

In any situation in which shareholders feel that an auditor has failed in their duty of care their first recourse should be to the Regulator. The Regulator should act promptly to establish whether there is evidence that the auditors have a case to answer. This process should involve all parties to the audit contract. The outcome should be made public as soon as possible with the Regulator stating the reasons for its conclusion and the remedies applied. Only in the most extreme cases should litigation be considered an option.

With regard to the routine management of the audit contract, it is appropriate that the audit committee should maintain daily and weekly contact with the auditor. It is also appropriate

that the audit committee should be directly involved in shaping and agreeing the auditor's plan of work. However, there also needs to be a system which allows the stakeholder group to have clearer oversight of the plan of work developed by the auditors and to monitor the progress and performance of the external audit tem. This should include being able to ask the auditors questions about their work and what they have found. If necessary, members of the stakeholder group should be able to meet with the auditor on their own and without directors or non-executive directors present. Formal reviews at end of one year / beginning of the next and in the middle of each year should be sufficient as a minimum

Too often it seems that the work of the internal audit function bears little relation to the issues addressed by the external auditor. The activities of the external auditor receive superficial mention in most annual reports. However, the activities of the internal audit team receive even less coverage – despite the fact that this is a critical business function. The stakeholder group, therefore, should also have a degree of oversight over the work of the internal audit team.

This is an area which should be of significant interest to shareholders. However, it is also an area in which input from employee representatives on the stakeholder group would be extremely valuable.

Clear guidance from the Regulator should be provided to help the members of the stakeholder group in performing this task. Again, appropriate training should be provided. At the AGM a member of the stakeholder group should be required to report to the meeting on the management of the external audit contract and key elements of the work of the internal audit team.

It has to be assumed that an auditor will only resign the audit contract or be dismissed by the company if serious disagreements have emerged and the working relationship has broken down. In this situation it is vital that shareholders are told exactly what has gone wrong. There are strong arguments for suggestion that the company should be forced to call an EGM so that both parties can be questioned by shareholders.

2.5 End of contract review prior to audit retender

Investors have to assume that companies carry out some sort of review of the audit contract when it comes up for re-tender. However, it is rarely clear what this involves. How rigorous is this process, what worked well, what didn't work so well and how should the specification for audit services be amended to take account of future and / or changing requirements when the contract is retendered? Shareholders are never told this.

This is another area in which stakeholder groups should be involved and in which they could make useful input.

3. Supply-side issues

All the large audit practices and many in the middle-tier offer consultancy services in addition to audit. It is not always clear whether the large global firms are auditors with a consultancy sideline or whether they are really consultants with an audit sideline. Looking at the 2017 results for two of the largest firms is revealing. Ernst and Young, for example, had UK revenues in 2017

of £2.35 billion of which £689 million was accounted for by assurance (audit) services. PWC had UK revenues of £3.8 billion of which assurance accounted for £1.3 billion. For these two firms true audit work accounts for 25 -30% of total UK revenue.

We have a number of concerns about the practice of audit firms offering consultancy services including:

- Where an audit firm has a large consultancy business, there are inevitably suspicions that the audit practice acts as a source of 'leads' for the consultancy business. Despite the limitations on the amount of consultancy that audit firms can carry out for their clients, the consultancy work can still be financially attractive. This can create conflicts of interest. It has the potential to distort good judgement and business culture.
- There is an incentive for audit partners to want to retain audit contracts; no one likes to lose business and audit partners may be under pressure from their own side to go along with the blandishments of senior client-management – particularly when the issue at stake is likely to affect bonuses on both sides.
- Rules designed to limit conflicts of interest by limiting the amount of non-audit work that auditors can do for a client have the perverse effect of limiting competition. If a FTSE 100 company tenders its external audit and the consultancy arm of one of the Big Four auditors is carrying out a large IT project for the company it may mean that the firm is excluded from bidding for the audit contract. If another firm is providing internal audit services (as with Deloitte at Carillion) it may be that there are really only two potential bidders, one of whom is the incumbent.

We believe that it would be better if audit firms did not provide consultancy services to large companies and public interest enterprises (PIEs). As indicated above there are serious potential conflicts of interest if audit partners are seen as a source of leads for the consultancy practice. For smaller accounting and audit firms servicing small, often local, businesses this is not an issue.

4. Conclusions

The issue of audit quality is a subject of great importance to private investors. Private investors are investing their own money (not somebody else's) and they want to be sure that:

- They have a clear understanding of the scope and purpose of the audit i.e. that there is a no mismatch between their expectations of the reassurance that the audit is providing and the levels of reassurance that the auditor believes he / she is reasonable able to provide.
- The information and opinions provided by the auditor are reliable as an aid to making investment decisions and performing their stewardship obligations satisfactorily, taking into account any agreed limitations and constraints. Investors want audits that are fit for purpose.

There have been a number of well-publicised cases recently which have caused investors to question whether audits have been carried out to a sufficiently high standard. Tesco, Carillion and Patisserie Holdings are just three of the most prominent recent cases.

However, this is not just an issue of whether quality could be better. In a number of cases there appear to have been fundamental audit failings which call into question the whole value of the audit process. Competitive tendering may have helped to control audit costs but low cost does not necessarily equal value for money. If the external audit is deficient it is a complete waste of money; if it provides false assurance to investors, it is misleading and is worse than useless.

The external audit is a service that is so important that it is worth expending more resource and paying more to ensure that the service purchased is fit for purpose. The vast majority of shareholders would subscribe to this principle.

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