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INVESTMENT MATTERS

The Investment Association Guidelines on Audit Tenders

January 2017

INTRODUCTION

These guidelines have been prepared by the Investment Association (IA), the representative body for the UK asset management industry and institutional investors in listed companies. In view of the recent increase in the tendering of audits and rotation of auditors, this guidance sets out the expectations of the IA's members, UK institutional investors, when companies tender their audits. It covers, inter alia: (1) planning the tender; (2) tender candidates; (3) the tender process; and (4) the tender decision.

The IA's members are key users of the information in a company's annual report and accounts. They want it to provide them with the information they need in making investment decisions and fulfilling their responsibilities as owners.

The fact that the annual report and accounts is subject to an audit is vital to investors' confidence in these companies in that the markets trust the information reported. However, investors are concerned when audit firms hold office for long periods in that this can be perceived to impact their integrity, independence and objectivity¹, each of which is important in ensuring audit quality. Thus they value the annual report and accounts being transparent about any audit tendering and rotation of auditors. In each section this guidance sets out the particular disclosures that investors find helpful.

One of the reasons for issuing guidelines now is that the mandatory auditor rotation requirement in the EU Audit Regulation became effective from 16 June 2016. This requires Public Interest Entities (PIEs)² to change their auditor after a maximum term of 10 years which can be extended to 20 years, or 24 years in the case of a joint audit, if a tender has taken place.

Whilst the Regulation applies to PIEs, these guidelines are aimed at companies whose shares are admitted to the Premium and Standard segment of the Official List of the UK Listing Authority, to trading on AIM, or to the High Growth Segment of the London Stock Exchange's Main Market.

1. PLANNING THE TENDER

1.1 Audit Committee to direct the planning and oversee the process.

The IA notes that the EU Audit Regulation requires the Audit Committee to be responsible for the tender process and the final recommendation to the board.

The IA's members support this in that whilst the tender process may involve operations and finance functions, oversight by the Audit Committee is important in the interests of ensuring the tender is managed and directed in the interests of a company's shareholders, to whom the appointed auditor is answerable and reports. The Audit Committee should direct the planning and oversee the process, including identifying candidates, setting the criteria for selection and the interviews. It should also ensure appropriate disclosures are made in its report in the annual report and accounts, or in an RNS

¹ Integrity, independence and objectivity are as defined in the Financial Reporting Council's Glossary of Terms (auditing and ethics) dated June 2016.

² A PIE, as defined, is an entity incorporated in an EU Member State with equity or debt listed on an EU regulated market; or a credit institution or insurance undertaking.

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announcement as appropriate. In this context, the whole Committee should be involved in that the tender should not just be the responsibility of the Audit Committee chair.



1.2 Plan carefully, well in advance.

The IA's members believe it vital that the Audit Committee ensures any tender is planned carefully and well in advance. Tendering has become more complex for PIEs following the implementation of the EU Audit Regulation. There were always restrictions on the type and level of non-audit services³. However, the Regulation has extended the list of prohibited non-audit services and for the first time capped permitted non-audit services⁴. Thus managing the mix of non-audit services is now more complex and likely to need time and input from a range of stakeholders. In view of this complexity, it is important that companies do not leave tendering to the last possible year. Moreover, as noted below, auditor selection should take priority over non-audit services.

1.3 Contact major investors.

The IA's members consider that when a company plans to enter into a tender it should issue an RNS announcement so that its investors can, if they wish, engage with it on the process. It should also contact its major shareholders and engage with them on the process. For example: on the timetable and process; how the Audit Committee intends to assess audit quality; the selection criteria and assessment mechanism that will be applied; and the conclusion reached.

1.4 Prioritise auditor selection over other services.

Given the importance of a quality audit to the capital markets, the IA's members consider it critical that companies prioritise auditor selection over other services, such as taxation and consultancy, when choosing professional advisers.

Companies should also ensure that those responsible for procuring professional services are aware of the restrictions on non-audit services and any plans to tender. An audit tender should be planned strategically to ensure the choice of candidates is maximised.

1.5 Audit Committee to give advance notice.

The UK Corporate Governance Code requires the Audit Committee to disclose its policies around audit tenders⁵.

Investors welcome an Audit Committee giving advance notice of a tender and the timetable. Thus investors can let it be known if they would like to be consulted during the process.

³ Non-audit services are any professional services provided to company by its auditor other than those provided in connection with an audit or a review of the financial statements of that company.

⁴ In respect of PIEs, the EU Audit Regulation prohibits certain non-audit services and caps allowed non-audit services at 70% of the average group statutory audit fees over the previous three years.

⁵ On a comply or explain basis the UK Corporate Governance Code expects a company's audit committee to disclose the length of tenure of the current audit firm and when a tender was last conducted, and to give advance notice of any retendering plans.

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The Audit Committee should avoid standardised disclosures and explain why it is proposing to tender at that time, particularly if it is retendering well within the new statutory limits. It is helpful if the disclosures clearly demonstrate that the Committee has ownership of the tender process.



2. TENDER CANDIDATES

Audit Committees need to consider the range of firms invited to tender, ensure that they are objective and independent, and also whether the incumbent is to be included.

2.1 Wide range of firms - not just the four largest.

The 2013 [report](#) of the Competition Commission (now the Competition and Markets Authority) on the provision of statutory audit services noted that the overwhelming majority of audits in the FTSE 350 are undertaken by one of the four largest audit firms: Deloitte; EY; KPMG; and PWC. For the four largest firms to dominate the audits of companies in the FTSE 350 is not healthy for competition and choice. Thus investors welcomed that from 16 June 2016, and the implementation of the EU Audit Directive and Regulation:

- Contractual terms that restricted an audited entity's choice of statutory auditor to certain categories or lists of firms are effectively prohibited.
- No audit firm which received less than 15% of its total audit fees from PIEs in the Member State concerned in the previous year can be precluded from the selection process.

To ensure confidence in corporate reporting, it is essential to have a well-functioning market for audit services. Investors expect a wide range of audit firms to be invited to tender and, where practical, firms other than the four largest should be included.

Each candidate should have a genuine prospect of being successful. Investors consider that, depending on each group's circumstances, only the larger multinational groups may have to restrict their choice to the four largest audit firms.

2.2 Integrity, independence and objectivity.

It is important that tender candidates have integrity, and are independent and objective, so that they are able to deliver a high quality audit. Non-audit services can potentially impair this in that the significant revenues from and the nature of such services can lead the auditor to identify himself with the interests of management rather than the company as a whole and therefore its investors.

As noted, the EU Audit Regulation extended the restrictions on the nature and level of non-audit services. Thus when considering potential candidates, more than ever, it is important that consideration is given to:

- Compliance with regulations, including 'cooling in' periods.
- Services that need transitioning.
- Other threats to integrity, independence and objectivity that remain and whether these can be mitigated by safeguards.

An Audit Committee's members often includes those that were previously a partner in, or employed by, an audit firm. This can give rise to a perceived conflict of interest if that audit firm is a prospective candidate.

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It is important that a balance is struck between ensuring the Audit Committee has the right skill set and managing such conflicts. Thus conflicts should be identified well in advance of the tender process. Investors' general preference is that at least three years should have elapsed from when a company director was a partner in, or employed by, an audit firm before the firm can be considered for appointment as auditor. That said, an audit firm may be appointed where the Audit Committee takes steps to manage and mitigate any conflicts. For example, by the conflicted member not voting on the final decision. Whatever the circumstances, it is important for the Audit Committee to explain how conflicts will be addressed in advance of the tender.

2.3 Address any advantage the incumbent may have.

The IA's members generally support the incumbent auditor being invited to tender unless they have served the maximum term possible under the EU Regulation such that a change of auditor is required. In which instance the tender process should address any potential advantage an incumbent firm, or an audit firm with a substantial business relationship with the company, may have and ensure there are appropriate mitigating factors. For example, the tender could include a specific case study to be addressed which none of the candidates would have prior experience of, and firms other than the incumbent could be given additional time for questions.

2.4 Transparency as to how candidates decided.

Investors would welcome Audit Committees being transparent about how they decided on the candidates to be invited to tender and consider disclosing:

- Any restrictions on a firm being able to tender.
- Whether any mid-sized firms will be invited to tender and an explanation where this is not the case.
- How any conflicts between Audit Committee members and tender candidates will be managed and mitigated.
- Whether the incumbent will be invited to re-tender.

3. THE TENDER PROCESS

3.1 Set clear objectives and selection criteria.

Investors also believe that for the tender process to be successful and focussed, clear objectives should be set as to what it wants to achieve and what is looked for in an auditor. The Audit Committee should agree the selection criteria and the weightings given to each. For example, the criteria may include the firm's reputation with the particular sector; the credentials of the audit team; knowledge of the business being audited; the use of technology; what audit quality means in the context of their company; and past experience of transition. The process needs to be fair and objective such that the candidates are on a level playing field.

3.2 People to interview.

When the interviews are held or presentations given, the interviewees/presenters from the audit firms should be the same individuals that will be working on the audit if their firm is appointed. For

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multinational groups it may also be helpful if the audit partner and teams responsible for the audit of key overseas divisions/subsidiaries are interviewed.



3.3 Factors to help with selection.

In deciding on the preferred candidate, the Audit Committee should consider a variety of factors which may include the following:

- The likely materiality thresholds used and the basis of the calculation.
- How informative the disclosures in the firm's audit reports are.
- Reports from the Financial Reporting Council's Audit Quality Review Team on the firm and how the firm is addressing any findings.
- IT capabilities, together with any recent innovations and how these will be used.
- The future capacity of the firm. For example, training and development, and resource planning. The relationship may well extend up to 20 years and these will be important considerations.
- Whether there are any conflicts now or likely to arise in the future.

3.4 Disclosure.

Investors would appreciate Audit Committees disclosing the selection criteria used, for example, audit quality, cultural fit, industry expertise, transition experience.

4. THE TENDER DECISION

4.1 The importance of audit quality.

In accordance with the EU Audit Regulation, the Audit Committee is now required to make the final recommendation to the board as to the preferred firm.

Investors want the auditor that will provide the highest quality audit selected and prospective auditors should demonstrate clearly that they can provide a quality service. The IA's members consider it important that the Audit Committee ensures that in making its recommendation it puts audit quality as its main criterion. In this context, it is important that fees are considered as part of the tender process in that they should be reasonable, i.e. not too low to suggest audit quality could be impaired and not too high as to be excessive. However, they should not be the main deciding factor particularly in the early stages of the tender process.

4.2 Investors' views.

The Audit Committee should consider seeking the views of the company's major investors before making the appointment particularly if there are issues, as highlighted in these guidelines, which they wish to discuss.

4.3 Transparency.

At the time the decision is confirmed, there should be an RNS announcement rather than delaying any announcement until the final Annual Report and Accounts is issued. Following the tender, the Audit Committee should consider reporting on the following:

- The various stages in the tendering process and the timetable.

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- How firms were assessed and the issue of fees addressed.
- Details as to why the firm concerned was chosen.
- A summary of the handover process.



Where investor input is received, the Audit Committee's report should consider explaining how it went about that engagement and the outcome.

ABOUT THE INVESTMENT ASSOCIATION

The IA is the trade body that represents UK investment managers, whose 200 members collectively manage over £5.5 trillion on behalf of clients.

Its purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money the IA's members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

More information can be viewed on the [website](#).