

Tendering your audit matters to shareholders

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Auditors require independence, professional scepticism and a willingness to challenge. It is one of the few independent functions of governance that is embedded within an organisation and reviews the detail of the business. For this reason, shareholders and other stakeholders place considerable weight on the assurance provided by an independent and high quality external audit.

Since 2011 LGIM has worked with other investors to improve the quality of, and trust in the audited financial accounts. We have been encouraged by the adoption of new regulations requiring the regular tendering and rotation of the external statutory auditor across Europe. The regulation requires the audit contract to be regularly re-tendered and sets a maximum time limit on auditor tenure.

Structured processes for tendering and rotating the auditor:

- Emphasise to all stakeholders that the audit is for shareholders
- Circumvent the development of relationships between management and auditors that may impede independence
- Ensure key judgements are challenged and reviewed independently by the incoming auditor

Given the importance placed on the external audit by shareholders, and the potential for over a decade-long relationship, it is essential that the audit tender is transparent and robust. The manner in which the tender is conducted will set the tone of the relationship between management, board, shareholder and auditor.

Shareholder engagement is particularly welcomed at the start of the audit tender process. It is expected that the audit committee chairman will proactively request to meet some shareholders.

Audit Tendering Best Practice

Preparing for the tender

Role of audit committee:

The audit committee has responsibility and ownership for the audit tendering process. It is important the whole committee is involved from the start of the process, including overseeing the planning stages, formulating criteria for selection, leading the interviewing process and ensuring there is appropriate disclosure to shareholders.

The audit committee should select any management and internal employees assisting in the tender process in order to ensure an appropriate balance of expertise and skill sets.

The Chairman should regularly liaise with the audit committee to ensure appropriate oversight of the process. On occasion, if the full audit committee is unable to commit to the audit tendering process, a sub-committee may be formed comprising independent directors.

Planning the tender process:

The regular tendering should be scheduled in relation to your company's requirements taking into consideration:

- The potential for complications and delays. We do not recommend leaving the tendering to the last possible year
- Alignment of the appointment of the new audit firm with the rotation of the audit partner
- Large strategic business and investment plans; including how planned mergers or acquisitions may impact a tendering process

Set a timetable for the tendering process:

- Once the request for proposal (RFP) has been published, the entire process should be restricted to a few months, if not shorter
- A specified (short) timetable will allow the pitching firms to allocate their resource appropriately

Continued overleaf...

The tendering plan should anticipate any potential advantage for the incumbent or for pitching firms with substantial business relationships with the company. Mitigating factors should be considered:

- Conduct the tender with a new audit partner and team
- Choose an unusual topic/issue
- Allow non-incumbents additional time for questions

Audit selection criteria:

The audit committee should define the selection criteria for the audit tender early in the process. Consideration should be given to quantifying the weighting to be applied to each criterion. Investors would welcome publication of the audit selection criteria in the annual report.

We encourage the inclusion of the following aspects in the audit selection:

- Disclosures and approach to the auditor report to shareholders
- Management, knowledge and criteria for the use of external partners and network firms. (For example, local language and transfer of information)
- Key risk areas and assumptions used by the audit firm. For example, materiality thresholds
- IT capabilities, including how these will be used to improve audit quality
- The future capacity of the audit firm. For example, research and development work and employee development processes. Given the potential length of the relationship, this may be an important consideration
- The use of independent metrics of audit quality. For example the UK's Financial Reporting Council's audit quality review reports and the equivalent for local partners

Other considerations:

It is expected that most companies would be approaching audit firms outside of the 'big four'. The only exception would be for the most complex and large multinational companies.

The audit tender must take priority over all other non-audit activity. We would not look favourably on potential bidders refusing to participate or not being invited to tender due to non-audit activity.

Identify key personnel across the business who will be involved in the process. It is helpful if internal teams understand the advantages and benefits of the tender.

Map the relationships, non-audit work and other potential conflicts with any potential bidders. This can be a considerable piece of work. The audit committee should decide whether any of these relationships or services causes potential irreconcilable conflicts and would need to be re-tendered. Audit committees may wish to consider greater monitoring of all new activity with potential bidders in the lead up to the RFP.

Disclosure to shareholders:

Prior to the tendering process, the audit committee's report to shareholders should include details of:

- Timetable for the tendering work
- The accounting period from which the new audit contract will be expected to start
- How conflicts, perceived or actual, with any alumni on the audit committee, board and executive team will be managed and mitigated
- How conflicts, perceived or actual, with the potential bidders and their audit teams will be identified and assessed.
- Whether the incumbent auditor will be invited to re-tender and any other restrictions on auditors tendering
- The invitation to mid-sized audit firms to tender, with an explanation where this is not the case
- Confirmation that the audit committee as a whole will be leading the tendering process
- Activities the audit committee will be undertaking in preparation for the tender

More than a beauty parade

The participants from the pitching firms should comprise the audit team who will be working on the mandate if successful. Global companies may wish to include the audit partners and teams that would lead on the audit of key overseas divisions / subsidiaries.

To be efficient with management's time and for a fair tendering process, we recommend setting boundaries for when management are contactable by the pitching firms and using group meetings to provide information to the pitching firms.

Assessment of the pitching firms should be more detailed than a "beauty parade pitch". The questions and presentations should be held with the participation of the audit committee.

The committee may consider splitting the tender into two or more parts. The first focussing on the 'pitch' by the audit firm; the second based on a task or a more detailed project that is specific to the company.

The committee may consider replicating a 'real-time' scenario mid-way through the tender process.

Making the decision

The final recommendation to the Board should be made solely by the audit committee.

Assessment of audit quality over cost is essential. It is recommended the first phase of the assessment be conducted based only on quality. However, as the first year of a possible 20 year relationship, it is essential fees are assessed thoroughly prior to finalising the appointment.

For the unsuccessful firms, it is recommended that constructive feedback is provided.

Handover of audit work

The auditor profession has a clear set of standards for the transition of the audit from one firm to another. However, for the most complex companies it may be useful for the new audit team to work alongside the incumbent for a period of time.

Non-audit work provided by the successful firm will need to be assessed. Under LGIM's voting policy, we consider on-going non-audit work worth greater than 50% of the audit fee to potentially be of concern.

Reporting the outcome

Disclosure following the tendering outcome is important to demonstrate the robustness of the tendering process.

We expect companies to publish a stock exchange announcement detailing the change in auditor at the time the decision is confirmed. We expect that the Annual Report following the tendering process should include the following information:

- Firms participating in the tendering process
- Confirmation of who was involved internally, at what stage of the process
- Explanation of how conflicts of interests were identified and managed
- Detail of tendering process, including timetable and a breakdown of the stages of the tender
- Summary of how the pitching firms were assessed by the audit committee, including the key areas used to assess pitching firms' quality
- Explanation of why the selected audit firm was chosen, including where they excelled
- Summary of the handover process between the audit firms

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