Which entities are required to conduct audit tenders?

The requirement to conduct an audit tender process at least every ten years applies to “public-interest entities”, a term which covers:

1. any issuer with transferable securities admitted to trading on an EU regulated market – for example, the Main Market of the London Stock Exchange
2. credit institutions within the meaning of the Capital Requirements Regulation (regulation no. 575/2013); and

However, given the importance of a high-quality audit, companies or groups of companies which do not fall within this definition may also decide that it is in their best interests to put their audit out to tender and adopt elements of the guidance referred to below.

What must the tender process involve?

At a minimum, the audit process must involve the following:

1. The audited company must invite audit firms to submit proposals for the provision of the audit service. In doing so, it cannot preclude the participation of firms which received less than 15% of the total audit fees from public-interest entities in the United Kingdom in the previous calendar year. In effect, this means that the process cannot be restricted to the “Big Four” firms alone.
2. The company must prepare tender documents which allow the invited firms to understand its business and the type of audit that is to be carried out. These documents should also contain transparent and non-discriminatory selection criteria which will be used to evaluate the proposals submitted by audit firms.
3. At the end of the process, the company’s audit committee must evaluate the candidates against the selection criteria and make a recommendation to the board of directors about the choice of auditor. In doing so, it is required to identify both its first and second choice candidates and give reasons for those choices.
4. Once a new auditor has been chosen, the company must prepare - and the audit committee must approve - a report on the tendering and appointment process. The purpose of this report is to allow the company to demonstrate to the FRC that the process has been carried out in accordance with the law.
Aside from these requirements, companies are largely free to run the tender process as they wish. However, as tenders have become more commonplace in recent years, best practice has emerged in relation to audit tenders and so we have summarised some of the key themes arising from the FRC and the Investment Association’s new best practice guidance.

**Forward planning is vital**

Firstly, the guidance reinforces the need for companies to plan their tender process well in advance of the ten year deadline.

Forward planning is important for a number of reasons. One reason is that it provides an opportunity to select the best possible point in time for the tender process to take place. In identifying the optimal time - which will not necessarily be the very end of the ten year period – companies should consider a number of factors, including planned operational or strategic changes in the business and any key dates for the retendering of non-audit services.

In addition, by setting the timetable for the process at the earliest opportunity, audit committees will maximise their opportunity to engage with shareholders on the details of the tender. The guidance indicates that investors are eager to be consulted on the key aspects of the exercise, including the choice of participating firms, the selection criteria and the methods of assessment utilised. By actively seeking the views of major shareholders and using these to inform their process, companies can ensure that they conduct the tender in a manner which will give investors confidence in the outcome.

At the other end of the process, forward planning will mean that audit committees are able to factor in enough time to facilitate the smooth transition of an incoming auditor. This might involve a period of shadowing during the final audit of the incumbent firm. Allowing for a reasonable gap between the conclusion of the tender process and a change of auditor will also give the incoming firm a chance to ensure that they comply with the relevant independence requirements. As one audit committee chair indicated to the FRC, “having sufficient lead-in time is key in managing transition risk”.

**The whole audit committee should be involved**

Another important theme is that the whole audit committee should be fully engaged with and involved in the tender process.

Given that it is the audit committee as a whole which is required to present recommendations to the board, every member of the committee, not just the chair, should be equipped with the requisite knowledge about the legal requirements outlined above and have a clear understanding of the tender process and its aims. The FRC suggests that companies could ask their company secretary or the incumbent auditor (provided that the incumbent is not a candidate in the tender) to provide a briefing on audit tenders to ensure that all committee members understand their responsibilities.

Once the company has ensured that each member of the audit committee is sufficiently knowledgeable about the process, the guidance indicates that the whole committee should be involved throughout the tender, including in the determination of selection criteria and the setting of technical challenges for candidate firms. If firms are invited to give presentations as part of the process, best practice is for all members of the committee to attend each presentation.

**Audit quality is crucial to investors**

Finally, a key message is that a high quality external audit is of great importance to investors.

This is reflected in the fact that the Investment Association is clear that auditor selection should be prioritised over other professional services. Where a firm already undertakes non-audit activity for a company, investors do not expect
this to prevent their participation in the tender process. Rather, companies should see audit as the “lead” professional service and base their procurement of other services around their auditor selection.

Moreover, although investors expect companies to consider fee levels when making their decision, the main criterion used by audit committees when making recommendations to the board should be audit quality rather than cost. In this regard, it should not be assumed that shareholders will welcome the company making an appointment which represents a reduction in their audit fee - investors are sceptical of fees which are too low and may tend to view them as suggesting a poorer quality of audit.

Ultimately, it is investors, rather than companies or their audit committees, who are the clients of auditors, and it is essential to them that companies adopt robust and carefully planned tender processes to maximise audit quality.

Your Key Contacts

**Brian Moore**
Partner, Edinburgh
D +44 33 0222 1897
brian.moore@dentons.com

**Guy Norfolk**
Partner, London
D +44 20 7002 8568
guy.norfolk@dentons.com

**Claire Armstrong**
Partner, Edinburgh
D +44 33 0222 1648
M +44 7747 472640
claire.armstrong@dentons.com