



## Audit firm retendering and rotation

On 22 November 2013, members of the European Audit Committee Leadership Network (EACLN) met in Rome to discuss audit firm retendering and rotation, among other topics.<sup>1</sup> The guests for this session included Professor Maurizio Dallochio, professor at SDA Bocconi School of Management and former audit chair of the European Investment Bank, and Dr Maurizio Lauri, chairman of the board of statutory auditors at UniCredit. For short biographies of Professor Dallochio and Dr Lauri, see Appendix 1, on page 12

This document summarizes the key points that guests and members raised in the discussion, along with background information and perspectives that guests, members and other experts shared before the meeting.<sup>2</sup> For further information about the network, see "About this document," on page 11. For a list of participants, see Appendix 2, on page 13.

### Executive summary

In the current public-policy environment, the issue of audit firm retendering and rotation is of increasing interest to audit chairs, who are concerned about the challenges of managing a successful audit firm transition for their companies and the audit profession more generally. Members looked to Italy, which has required rotation every nine years since the 1970s, as an emerging source of best practice in managing audit firm transitions. The discussion in Rome focused on the following topics:

- **Pressure to retender or rotate the audit is increasing** (Page 2)

Policymakers are beginning to require retendering and rotation of the audit firm at specific intervals. Regulation on mandatory audit firm rotation is in the final stages of the European Union's legislative process and is likely to become law in 2014. Meanwhile, the Netherlands has enacted legislation imposing an eight-year rotation period effective January 2016, while the UK Competition Commission has published a final report requiring FTSE 350 companies<sup>3</sup> to retender their audits every 10 years. Members also mentioned other triggers for retendering, including pressure from some investors and the expectations of the public in general.

- **Companies and boards should manage the retendering and rotation process carefully** (Page 4)

Guests and members noted that the retendering process involves input from various internal groups, though one group or individual typically takes the lead (increasingly, the audit committee, or, in Italy, the board of statutory auditors;<sup>4</sup> in Italian, the *collegio sindacale*). While audit fees and the independence of the firm in terms of non-audit services are important considerations, the selection criteria used to evaluate audit firms also encompass the quality of the staff, including their knowledge of the firm's sector, the character and authority of the senior partner, and the firm's processes for coordinating operations across multiple national jurisdictions and resolving different points of view on technical matters. Planning for the transition is critical and may even include evaluating the audit firm's transition strategy during the

<sup>1</sup> In another session, members discussed board and audit committee composition with Dominic Schofield, senior client partner at Korn/Ferry International. See European Audit Committee Leadership Network, "Board and Audit Committee Composition," *ViewPoints*, 10 January 2013.

<sup>2</sup> *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

<sup>3</sup> FTSE 350 companies are the 350 companies with the largest market capitalization whose primary listing is on the London Stock Exchange.

<sup>4</sup> See the box on page 5 for more information on Italian practice.

retender process. Building in sufficient overlap between the two firms allows for better transfer of knowledge, and effective dialogue and review of working papers should be encouraged. Management and audit committee support for the new auditor also plays an important role, with transparency and openness the keys to building a successful relationship.

▪ **Retendering and rotation will have significant effects on the audit profession** (*Page 9*)

In addition to presenting challenges for companies, mandatory retendering and rotation is likely to have a major impact on the audit firms and the broader audit profession. Guests and members were concerned about the potential consequences resulting from downward pressure on audit fees. They saw reduced competition as a rise in retenders strains the ability of audit firms to respond to every tender request. Negative impacts – such as the cost of mounting thousands of tender responses – may make the audit profession increasingly unattractive to top talent, further undermining audit quality.

For a list of discussion questions for audit committees, see Appendix 3, on page 14.

### Pressure to retender or rotate the audit is increasing

The independent audit of company accounts has drawn considerable attention from regulators, policymakers and some investors in recent years. The financial crisis caused certain stakeholders to conclude that there are fundamental problems with the audit profession and its relationships with its clients. One concern voiced by some policymakers is that auditor independence and objectivity could be compromised by the long tenure of audit firms with their clients.<sup>5</sup> The proposed solutions include various forms of mandatory retendering and/or rotation of audit firms. When enacted, these policies will force many companies to undertake those processes, including companies that have had little experience of either.

### Policy initiatives in the European Union and member states

Legislation on audit policy reached the last stages of the EU legislative process in December 2013, when the European Parliament and the Member States agreed on a final set of rules. In the key areas of contention, the rules roughly split the difference between the European Commission's original position and the Parliament's subsequent amendments. In his statement on the agreement, Michel Barnier, European Commissioner for Internal Market and Services, laid out the key provisions:<sup>6</sup>

- **Mandatory rotation.** Maximum audit firm tenure will be 10 years, which will be extendable to 20 years with retender at 10 years or 24 years with joint audit.
- **Non-audit services.** Certain non-audit services will be prohibited, and permissible non-audit services will be capped at 70% of the audit fees.

The agreement needs formal ratification by the Member States and the Parliament. Once ratified, it will be phased in over a period of several years to “avoid a cliff effect.”<sup>7</sup>

Italy, meanwhile, has had mandatory nine-year audit firm rotation in place since 1974. Significant activity in the area of audit policy has taken place in some other member states, though with varying outcomes:

<sup>5</sup> See, for example, European Commission, *Green Paper: Audit Policy: Lessons from the Crisis* (Brussels: European Commission, 2010).

<sup>6</sup> Michel Barnier, “[Commissioner Michel Barnier welcomes provisional agreement in trilogue on the reform of the audit sector](#)” (Brussels: European Commission, 17 December 2013).

<sup>7</sup> [Ibid.](#)

- **The Netherlands.** In December 2012, the Netherlands approved new legislation imposing an eight-year rotation period and restricting the non-audit services that auditors can provide. The restrictions on non-audit services took effect on 1 January 2013, though there is a two-year transition period for pre-existing contractual obligations. The effective date for mandatory rotation is 1 January 2016, so companies that will have had the same auditor for eight consecutive years on that date will need to change the auditor before that date.<sup>8</sup>
- **The United Kingdom.** In October 2013, the UK Competition Commission published a final report that required FTSE 350 companies to tender their audits at least every 10 years.<sup>9</sup> The Competition Commission expects the rule will come into force from the last quarter of 2014.

In contrast, the US House of Representatives has voted overwhelmingly in favor of a bill to ban mandatory rotation. The July 2013 vote, observers noted, was a strong message to the Public Company Accounting Oversight Board that it should abandon mandatory rotation as an option in its efforts to improve audit quality, though the proposal has not been addressed by the Senate yet.<sup>10</sup>

### Other triggers for retendering and rotation

In addition to emerging regulations, EACLN members mentioned several other reasons that companies might choose to retender their audit and even switch their auditor, some of which are becoming more urgent in the current environment:

- **Pressure from investors.** While investors are divided on the merits of rotation, one group of institutional investors is supporting more frequent rotation. Led by the Universities Superannuation Scheme Investment (USS) and RPMI Railpen, both based in the United Kingdom, this group developed a position paper on audit policy in the autumn of 2012 that has been signed by over 30 other institutional investors across Europe.<sup>11</sup> The paper calls for maximum audit tenure of 15 years. In April 2013, USS and Railpen announced that they would begin voting against proposals to reappoint the independent auditors at FTSE 350 companies if the auditors' tenure at those companies exceeded 15 years.<sup>12</sup> Although it is early in the process, at least one member mentioned seeing some pressure from shareholders to consider changing the auditor. Another member, speaking after the meeting, said, *"We will increasingly have to factor in a more robust position from shareholders."*
- **Dissatisfaction with audit firm performance.** If problems with the audit or the interactions with the auditor are serious enough, they may prompt a decision to find another auditor. A member said, *"We had a bad experience on an impairment issue with a firm, and it should have been spotted sooner."*
- **Mergers.** If two merging companies have different auditors, the combined entity will typically reflect on the merits of both and select one of them to be the new auditor.
- **Routine good practice.** A few members said simply that periodic assessment in the form of retendering is good practice, even in the absence of specific problems. *"Society expects audit committees*

<sup>8</sup> Ernst & Young, *New legislation covering "Organisaties van Openbaar Belang" (OOB)* (London: Ernst & Young Global Limited, 2013), page 7.

<sup>9</sup> UK Competition Commission, *"CC Finalizes Measures to Open up Audit Market,"* news release, 15 October 2013.

<sup>10</sup> Tracy Alloway, *"US lawmakers block 'auditor rotation'."* *Financial Times*, 9 July 2013.

<sup>11</sup> The paper, entitled *Audit – A Long-Term Investor Position Paper on Proposed EU Reforms*, is periodically updated with new signatories, at which time its publication date is also updated. The latest version is dated 5 March 2012.

<sup>12</sup> USS Investment Management and RPMI Railpen, *"USS Investment Management & RPMI RAILPEN to Vote against Audit Firm Re-appointments,"* news release, 26 April 2013.

*to go through such a process at appropriate intervals,” one remarked. Another said, “Every year, we have a review with the internal auditor, finance group and audit committee on whether to keep the external auditor or not.” One member noted that the required rotation of the audit partner every five to seven years may be a natural trigger for a broader review of the options available. Another member said it would be natural to consider a retendering when the audit chair changes: “The new audit chair should have the opportunity to take another look.”*

Members have often noted, however, that retendering the audit and switching to a new auditor are never steps to be taken lightly. They have remarked on how long and costly the process can be, and on how the drawbacks of a new auditor, such as a lack of knowledge about the company, must be weighed against the benefits of “fresh eyes.” The drawbacks can be exacerbated under certain circumstances, such as during a CFO succession or a major restructuring at the company. These considerations have led members to argue that the board of directors and management need some flexibility over the timing of retendering, which a mandated timetable does not allow for.

### **Companies and boards should manage the retendering and rotation process carefully**

Though retendering and rotation may become more common in the future, many audit committee members note that they have not had extensive experience with either. While retendering the audit is similar in some respects to evaluating an incumbent auditor, EACLN members have remarked in previous meetings that a tender is more complex and time-consuming, demands more engagement from management and involves additional evaluation criteria.<sup>13</sup> Rotation has been even rarer than retendering, and it has the potential to be even more disruptive. Audit chairs are interested in learning more about best practices relating to both practices. In discussions before and during the meeting, guests and members offered pointers on the process based on their experiences so far, including experiences in jurisdictions where some form of mandatory rotation already exists or has recently been imposed, such as Italy and the Netherlands.

#### **The board of statutory auditors in Italy**

In addition to the board of directors, most Italian companies have a governance body known as the *collegio sindacale*, or board of statutory auditors.<sup>14</sup> While the board of directors consists of both independent and non-independent directors, the collegio is made up exclusively of independent members appointed by the shareholders. Members of the collegio must be registered as professionals in law or economics, or be university professors in these fields, and at least one member and one alternate member must be registered in the Register of Certified Auditors.<sup>15</sup> By law, the chair of the collegio is selected by the minority shareholders as a balance to the board chair selected by majority shareholders. *(Continued on overleaf)*

<sup>13</sup> See European Audit Committee Leadership, “Evaluating Audit Quality and the External Auditor.” *ViewPoints*, 3 July 2012.

<sup>14</sup> Since 2003, Italian companies have had the choice of implementing two other types of governance systems, which are comparable to the unitary and two-tier board systems common in the rest of Europe, but most companies have retained the traditional system.

<sup>15</sup> Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, *Corporate Governance in Italy – the Collegio Sindacale* (Rome: Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, 2009), page 7.

## The board of statutory auditors in Italy (*continued*)

The collegio sindacale performs many of the oversight functions performed by audit committees in other jurisdictions, especially functions involving compliance.<sup>16</sup> According to Italy's National Council of Certified Accountants and Auditors, the collegio oversees the following:<sup>17</sup>

- Compliance with the law and company bylaws
- Respect of the principles of correct administration
- Adequacy and functionality of the company's organizational, administrative and accounting systems and internal control systems
- Supervision of financial reporting and related auditing

The board of directors has a committee on internal control and risk that performs those functions of a typical audit committee that are not performed by the collegio, especially oversight of risk management.

The job of selecting the external auditor falls to the collegio, which manages the process, makes a selection and presents its choice to shareholders for approval. As the chair of an internal control and risk committee noted, "The internal control committee provides input, but it is pretty removed from the process. What they select, we get."

## The tender process

Several members said that the tender process is "*complex and time-consuming*," and care must be taken to ensure that it is properly managed. The finance function, internal audit, the audit committee and even the CEO may all be involved. A member described the process during a recent tender: "*We had all the stakeholders involved. The audit committee and the [board] chairman were in one group, and the CEO and CFO were in another group. They met separately since they have different perspectives. In the first round, we all had meetings with each firm. Different stakeholders had different interests.*"

One member noted that tensions can emerge when different perspectives lead to different preferences. Recent best-practice guidance on audit retendering from the UK Financial Reporting Council (FRC) notes the importance of setting clear objectives that are agreed upon by all the decision makers.<sup>18</sup>

The group or individual that takes the lead varies from company to company. A member said, "*It's good to have someone managing the process. We had someone doing it in the financial function. You need to make sure it's a fair and open competition.*" Another member said, "*The head of internal audit and risk is structuring the process. It involves a lot of time for him and for the CFO and his organization. But it is very interactive: he proposes, and the audit committee chooses between alternatives.*" Other members noted that the audit committee leads the process, and an EY partner in the United Kingdom noted that leadership by the audit committee is becoming more common.

<sup>16</sup> Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, *Contribution to Consultation Regarding the EU Corporate Governance System* (Rome: Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, 2011), pp 3–5.

<sup>17</sup> Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, *Corporate Governance in Italy – the Collegio Sindacale*, page 4.

<sup>18</sup> Financial Reporting Council, *Audit Tenders: Notes on Best Practice* (London: Financial Reporting Council, 2013), page 2.

In a pre-meeting conversation, an EY leader in Italy described the interaction between the collegio sindacale and the internal control committee in Italian companies: *“In a well-structured group, the two committees do work together, though from the legal point of view, the selection criteria and the evaluation of proposals are in the hands of the collegio.”* As in non-Italian companies, other groups play a role: *“Most effective is that you have the members of the collegio working with the CFO and the internal audit function, so there is a direct dialogue with the real buyer of professional services.”* At the meeting, Dr Lauri noted, *“This has been a time-consuming activity. At least three senior management people have been dedicated full-time to managing the bid, sourced from internal audit and the finance organization.”*

Several participants brought up the importance of educating the contending audit firms about the scope of the audit and the business, using a variety of approaches. Dr Lauri described the process: *“We presented to the bidders a detailed audit scope, and we gave them all of our entities plus all the hours broken down by each country and each entity. We issued an RFP [request for proposal] and organized meetings for each audit firm to clarify the RFP.”*

Professor Dallochio remarked, *“During the tendering process, partners and senior team members should be exposed to at least a three-day seminar on the company, on how the business works, key people, key processes etc.”* A member mentioned similar steps: *“We are now briefing three contenders in workshops and organizing visits for them around the world.”* However, the heavy impact of some of these approaches on the audit firms that must simultaneously manage their response to hundreds of tenders in different countries was not lost on the participants (see page 10). One member mentioned the establishment of a centralized *“data room”* for facilitating information exchange.

A few members mentioned the importance of getting references, especially regarding the analytical and emotional intelligence of the partner. A member said, *“Talking to the audit committee chairs of former clients is very important.”* One member recommended getting to know other external auditors in advance of the tendering process by using them to provide non-audit services.

## Selection criteria

EACLN members and experts discussed the most important selection criteria applied to the bidding firms, covering quality, cost and implications for non-audit services:

- **The audit plan.** Members mentioned the importance of understanding the approach the auditor plans to take in conducting the audit. A member said, *“You ask people to write up in detail how they are going to do the assignment. You measure how they will work.”* One member described giving the bidding firms key parameters about the company around which to develop their audit plan.
- **Sector expertise.** Given that different industries present different challenges for an auditor, it is important to select an auditor with sufficient sector experience. The EY leader in Italy said, *“For sure, companies look at industry-specific knowledge. They look at other clients the firm has in that industry.”*
- **Staffing of the engagement.** Several members highlighted the importance of making sure that the firm has competent staff in areas that are critical to the company and that the right people are assigned to the engagement. One member explained, *“Given all that we have to worry about, you have to make sure you have talent locked up in many areas: tax, corruption and bribery, exposure to the US or to emerging markets. What are the key areas and danger points? Where do you have to be sure you have the talent locked up?”* The member noted that *“you have to be sure that there is clear commitment from*

*the appointed firm on staffing. One has to be very clear on who is going to be on the team and for how long.” Dr Lauri underscored the same priority, specifically vis-à-vis the seniority of the staff: “We placed limits on the percentage of junior staff. We wanted a high percentage of senior partners and managers. This was not negotiable.”*

- **Global reach and integration.** Several members also pointed out that for large global companies, it is critical that the audit firm is capable of auditing remote offices effectively. A member said, *“We also look at the way the firm is integrated on a worldwide level in order to serve clients with operations on different continents.”* Another member added, *“One area where I’d be more thorough is the depth of local staff in key countries.”* One member drew out the implications for the structure of the firm: *“Accidents are happening everywhere, especially in distant places where controls and management are weaker. It’s a plea for an integrated auditor and not networks [of audit firms]. It’s more expensive to be an integrated firm. Networks have looser relationships, but they don’t control [affiliates] and check the work as carefully.”*
- **Efficacy of the consultation process.** A few members and experts said that getting a sense of how well the company resolves difficult accounting issues is important. An EY partner remarked, *“Quite often, the finance department is interested in the way the firm is organized regarding current consultation matters relating to IFRS. How is the IFRS desk organized? Also, they are interested in the mechanism for resolving a technical dispute, to be sure that the consultation process is fast and efficient and properly managed.”* At the meeting, Dr Lauri noted that it is important to assess the process for resolving differences: *“We also evaluated the firms’ governance – how they coordinated between the local teams and the global organization. If they clash, there is a problem.”*
- **Character and authority of the senior partner.** A member said, *“So much is the courage of the partner. They can be a brilliant domain expert, but unless they have courage, it won’t help the audit committee ... There are too many audit presentations where they are just trying to please someone. We don’t get enough straight talk, where they are looking forward. We need to have mistakes pointed out.”* At the same time, another member noted, the partner should be able to challenge management in a way that supports a good relationship, and one way to gauge that is to ask the bidding partners about the largest crisis that they have experienced and how they handled it.
- **Audit fees.** One member said, *“You can’t measure quality before the fact, so price is a metric.”* Another member noted, *“Cost is an important point, but cost alone would be far too simplistic, and audit quality trumps cost.”* Dr Lauri said that one important function of the collegio sindacale is to convince management that paying as little as possible is not a good idea. Describing his experience at UniCredit, he said, *“We placed a floor on fees. We didn’t want the cheapest auditor available. We started with the current fees, then did a benchmark of our competitors and detailed an appropriate level of fees. If they give you cheap fees, you will pay elsewhere later.”*

Nevertheless, a member noted, *“If you don’t pick the lowest-cost firm, you have to have a reason.”* At the meeting, a member said, *“You should usually view rotation as an opportunity. We saw a double-digit reduction in fees as a result of tendering, without sacrificing objectivity.”* Professor Dallocchio said that while his studies have confirmed that rotation puts pressure on fees, they also revealed a twist: *“Fees are the key ingredient in bidding, if not the only ingredient. In the first year, fees decline noticeably. But in the second year and third year, fees go up significantly, catching up so that there is not a real savings.”*

- **Independence as determined by non-audit services.** The auditor's independence, as determined by the nature and percentage of non-audit services it provides to the company, is a critical variable that typically must meet certain regulatory requirements. Companies will need to consider the implications for non-audit services of hiring a new audit firm. A member remarked, *"The other firms are all doing work for us. We'll ask all three to bid, which means that there will be rotation of the other work, too."* Earlier this year, the asset manager Schrodgers had to reinstate its previous auditor after discovering that its newly appointed auditor did not meet regulatory requirements for independence.<sup>19</sup>

An EY expert noted that some companies are proactively planning their procurement of audit and non-audit services to be sure independence issues do not arise. At the meeting, a member said, *"There are benefits to keeping things in a tight time frame, but if we had to do it again, we would start three months earlier to address independence concerns."* Another member saw the need for a much longer lead time: *"We plan the process two years in advance to ensure independence."*

The best-practice guidance on audit retendering from the UK FRC mentions many of these same selection criteria, also adding such dimensions as audit team structure and cultural fit with the company.<sup>20</sup> The National Association of Corporate Directors in the United States also highlights the audit firm's use of technology, its ability to make use of internal audit's work (and the effect on fees) and the firm's quality control system.<sup>21</sup>

## Achieving a smooth transition between audit firms

If a company has selected a new auditor, it faces the challenge of managing the incumbent while installing the replacement. As with tendering, the Italian experience is instructive, but systematic research into the best practices around the transition is not extensive, in Italy or elsewhere. The UK's FRC solicited input on the transition process during the roundtables it hosted and found that few companies reported significant problems.<sup>22</sup> Members, experts and the FRC brought up several practices that can smooth the transition:

- **Plan the transition well in advance.** A smooth transition takes time: one member reported, *"We will make the decision a year before the new auditor starts, so we will have a year to set up the transition."* The FRC suggests that the company can incorporate transition planning into the tender process by asking the competing firms how they would manage the transition.<sup>23</sup> Dr Lauri noted that the selection criteria can include the auditor's knowledge of the company from previous engagements. At the meeting, an EY partner underscored the importance of a partner at the incoming firm taking charge: *"You should expect to have a 'transition partner' who will have the mandate to manage the process, including minimizing the inefficiencies through a project management office, maximizing the fresh view and creating structures for feedback."* The company should also have a project management office.
- **Build in sufficient overlap between the two firms.** Audit committees and management should not assume that there will be adequate collaboration between the outgoing auditor and the incoming one. An EY expert in Italy said, *"You need to make sure there is sufficient overlap time so that knowledge is*

<sup>19</sup> Vanessa Kortekaas, "PwC Returns as Schrodgers Auditor." *Financial Times*, 25 March 2013.

<sup>20</sup> Financial Reporting Council, *Audit Tenders: Notes on Best Practice*, pp 7–8.

<sup>21</sup> National Association of Corporate Directors, *The Audit Committee* (Washington, DC: National Association of Corporate Directors, 2010), page 72.

<sup>22</sup> Financial Reporting Council, *Audit Tenders: Notes on Best Practice*, page 8.

<sup>23</sup> *Ibid.*

*effectively transferred to the new firm. An overlap of 6 to 12 months is very important. There is dialogue between the new auditor and the former auditor and a review of working papers.”* The FRC suggests that the new auditor be involved in key stages of the outgoing firm’s last audit, and one member mentioned a case in which the incoming auditor shadowed the incumbent for almost two years, working on the transition full-time.<sup>24</sup> The audit committee can also request that staff of the incumbent firm be frozen in place at the client to ensure effective knowledge transfer. Professor Dallochio highlighted the importance of transferring knowledge about the peculiarities and complexities of the business and the systems and procedures used.

The expert and members noted that if rotation is mandated and regular, the outgoing auditor has an incentive to cooperate. As a member put it, *“We expect them to play nicely. They have an incentive to do so – their colleagues are taking over at other companies.”* Down the road, too, the roles of the two auditors at the company in question may be reversed.

- **Provide management support.** Management also plays an important role in assisting the new auditor. Under some circumstances, management, typically the finance function, may be the chief steward of the process. One observer of the process in Turkey explained that in that country, because the working papers of each audit firm are structured differently, it may fall to management *“to explain everything to the new firm.”*
- **Provide audit committee support.** Dr Lauri brought up the role of the audit committee in the transition: *“You must build a strong relationship with the new external auditor. Share your experience and knowledge of the company to help guide them. Define your responsibilities as an audit committee. Identify major audit risks for them to avoid and that they may have overlooked because of their lack of experience.”* A member said, *“Make sure you have a great relationship with the new auditor. Be very open. Nurture the relationship.”*

## Retendering and rotation will have significant effects on the audit profession

Participants in the meeting explored the broader implications of retendering and rotation. With tendering and/or rotation now an imperative for many companies due to new regulations or other pressures, certain challenges present themselves for both the companies and the audit firms. Moreover, a regime of mandatory rotation may have second-order effects on the audit profession and audit quality.

### Market dynamics when rotation is initially imposed

The imposition of rotation can cause a flurry of activity in the market for audit services, as companies scramble to comply. With each company knowing that every other company is trying to find a new auditor as well, the general imperative is to get ahead of competitors so as to have the greatest choice and hire the auditor that is most appropriate for the company’s needs. An EACLN member observed, *“Everyone is trying to jump the gun in the Netherlands, so the matchmaking process has begun. It’s like an American prom system. The audit committee would be remiss if they were not trying to get ahead of it.”* A complicating factor is a lack of harmonized rotation periods among countries.

At the meeting, EY partners described the impact of the new requirements on audit firms in the Netherlands: *“In the Netherlands, the market will churn in two to three years. For EY, three out of the*

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<sup>24</sup> [Ibid.](#)

*four largest banks in the Netherlands will no longer be our clients. That is a huge volatility. There's a complexity [regarding] retaining people. We need to retrain those serving banks for corporate business. Now we are integrated, we will try to shift our Dutch people to be deployed with other countries."*

Unfortunately, as an EY partner in the United Kingdom noted in a pre-meeting conversation, partners may not be readily transferable, given the importance of their relationships and reputations in a specific country, as well as licensing and language requirements.

### **Impact on audit fees**

Participants brought up the dynamics that frequent tendering can generate around audit fees. Given that one benefit of tendering – at least in management's eyes – is the reassessment of audit fees, a potential impact of more frequent tendering is a trend toward reduced fees. An EY partner in Italy said that *"in Italy, many times there is very strong pressure on pricing ... The vast majority of audits are in the hands of the Big Four, but it is also true that there is strong competition among the Big Four."*

Members were concerned that the pressure on fees, even if short term, might adversely affect audit quality. One member observed, *"Fees are always reduced. The only way for firms to react is to reduce the time spent in order to reduce cost. Reducing time could be about efficiency, but it could also be about reducing coverage. Is this what we want?"* Another member concurred: *"You can only drive down fees so much before there is a quality issue."*

In a meeting with investors also held in Rome, a member noted that mandatory rotation meant *"fees tend to go down, which is good for the company and bad for the audit profession."* Jeannette Andrews of USS, a guest at that meeting, said, *"We take a different view on fees than management. It's not a cost: audit is an asset for us. A better-quality audit is a good thing."* Deborah Gilshan of Railpen, another meeting guest, agreed: *"Audit is an investor protection mechanism."*

### **Impact on competition**

Professor Dallocchio also noted that there is no evidence that rotation increases competition from non-Big Four firms, which is often cited as a rationale for mandatory rotation: *"Look at the concentration of the Big Four in the EU and in Italy. In 2010, there is 95% concentration of the Big Four in countries where rotation is mandatory. Where rotation is not mandatory, concentration of the Big Four is only 68%."*

In fact, members, guests and EY partners noted that a sharp increase in the number of retenders could even decrease competition among the Big Four firms, as the expense of bidding for audit work puts an upper limit on the number of audits each firm can bid on. In the meeting with investors also held in Rome, a member observed, *"It is expensive for the external auditor to play, especially when they think they may not have a chance, or if they have significant non-audit work with your company. So it is harder to get the proper competition."* Reflecting on the practices that emerged during the discussion of retendering, an EY partner expressed concern about the potential burden on audit firms if such practices became widespread: *"We couldn't cope with the volume of work that would be demanded of us."*

### **Other impacts on audit quality**

Professor Dallocchio explained that rotation also has effects on quality that are independent of the effect on fees: *"There is a strong correlation with the suspension of partners in the first two years when the new firm*

*is appointed. There is more probability that mistakes will take place in the first two years of an audit. Carried out properly, detailed audit analysis requires knowledge of the company and its people.”*

An EY partner spelled out some of the longer-term implications of mandatory firm rotation for quality: *“The increase in volatility will increase concentration. It will accelerate consolidation. Every firm will want 25% market share to avoid local volatility. To achieve that, our teams will need greater mobility across Europe. Our fear is that we will deplete quality and talent. And there is a high risk that the audit business will shrink. We will have to consider not [responding] to tenders – because of the volatility risk, we may not be interested. Audit partners may then leave because there is a bigger risk and a significant impact on our business growth opportunities.”*

## Conclusion

Given increasing pressures to retender and even rotate the audit, audit chairs are interested in how companies, boards and audit committees can reduce the costs of these processes and ensure that their impact on audit quality is positive rather than negative. Both the retender and the transition from one auditor to another must be managed carefully. *“Audit is not a commodity,”* Dr Lauri noted, so the team handling the selection of a new auditor should strongly weight a number of other factors besides cost. To facilitate the transition, early planning and sufficient overlap between the two auditors are important. Audit chairs and experts noted that the broader impact of mandatory rotation on the audit market and profession present additional concerns, as increased volatility, the number of retenders and the pressure on fees strain the ability of audit firms to respond to proposal requests, retain talent and maintain quality.

## About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavor to fulfil their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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## Appendix 1: Guest biographies

### **Professor Maurizio Dallocchio**

Professor Maurizio Dallocchio is a professor of corporate finance at Bocconi University, Milan. He is also past dean of SDA Bocconi School of Management, where he chaired the corporate finance and real estate department for more than 10 years. He studied at London Business School and New York University's Stern School of Business, where he has also been a visiting scholar. Professor Dallocchio has taught and conducted research widely around the world, including at CEIBS Shanghai, London Business School, IMD Business School of Switzerland and Stockholm School of Economics.

As a licensed public accountant and auditor, Professor Dallocchio concentrates his research mainly in corporate finance, and particularly in corporate valuation and mergers and acquisitions. He is the author of more than 80 publications and coauthor of *Corporate Finance* (Wiley), one of the most popular textbooks worldwide in its field. He serves on several prestigious advisory boards of both domestic and international organizations. On several occasions he has been a member of governmental study commissions. He has been a member and then chairman of the audit committee of the European Investment Bank (EIB).

### **Dr Maurizio Lauri**

Dr Maurizio Lauri is chairman of the board of statutory auditors at UniCredit and a partner in Studio Lauri Lombardi Lonardo Carlizzi. He is also member of the board of statutory auditors at ANAS, Tirreno Power, GDF SUEZ Produzione, GDF SUEZ Rinnovabili, Helio Capital and Cosmic Blue Team.

Dr Lauri was appointed by the chairman of the Senate of the Republic of Italy and the chairman of Chamber of Deputies of the Parliament of Italy to the board of experts for the audit of financial statements released by Italian political parties during the 16th legislative session (29 April 2008–22 December 2012). He is also a former chairman of the board of statutory auditors at Agenzia delle Entrate (the Italian Revenue Service).

For the Municipality of Rome, Dr Lauri has been a member of the committee on corporate governance and of the committee on budgeting and controlling. He was a member of the committee on corporate governance of the Italian Institute of Chartered Accountants.

Dr Lauri is a former member of the board of directors of Lauda Air, Gambero Rosso and Habanos in Italy. He is also a former sole director of Servizi Azionista Roma, the company of the Municipality of Rome dedicated to offering support to the Municipality acting as a shareholder in connection with issues related to financial statements, budgeting and reporting, company law, tax law and the management of controlled companies.

Dr Lauri is also a professor of tax law at LUISS Business School, LUISS University in Rome.

## Appendix 2: Participants

Members participating in all or parts of the meeting sit on the boards of nearly 40 large-, mid- and small-capitalization public companies:

- Mr Les Brun, Audit Committee Chair, Merck\*
- Mr Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- Mr Carlos Colomer, Audit Committee Chair, Telefónica
- Mr Ángel Durández Audit Committee Chair, Repsol
- Dr Byron Grote, Audit Committee Chair, Unilever
- Mr Lou Hughes, Audit Committee Chair, ABB
- Dame DeAnne Julius, Audit Committee Chair, Roche
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Mr Hans-Joerg Rudloff, former Audit Committee Chair, Rosneft
- Ms Guylaine Saucier, Audit Committee Chair, AREVA
- Mr Jakob Stausholm, Audit Committee Chair, Statoil
- Mr Jack Tai, Audit Committee Chair, Royal Philips Electronics
- Ms Martine Verluyten, Audit Committee Chair, STMicroelectronics and Thomas Cook
- Dr Bernd Voss, Audit Committee Chair, Continental AG
- Mr Mario Zibetti, former Chairman, Internal Control and Risk Committee, Fiat Group

EY was represented in all or parts of the meeting by:

- Mr Christian Mouillon, Global Risk Management Leader
- Mr Mark Otty, Area Managing Partner, EMEIA
- Mr Felice Persico, Global Vice Chair, Assurance

\* *Member of the Audit Committee Leadership Network of North America*

### Appendix 3: Discussion questions for audit committees

- ? What regulatory requirements regarding retender or rotation do you expect will affect your company? Are you watching developments closely? Are you considering retendering in anticipation of regulatory changes?
- ? Is your company anticipating a dash to tender by many companies in your jurisdiction? How are you planning for such a dash? What strategic considerations come into play?
- ? How often has your board or audit committee evaluated the audit firm and considered whether or not to retender the audit?
- ? In addition to regulatory requirements, what other reasons might compel your company to retender and possibly rotate the audit? Have you felt pressure from investors or other groups?
- ? What are the most important elements of a tender process? What stakeholders should be involved, and how do they provide input? Who manages the process? What is the role of the audit committee?
- ? What are the most important selection criteria? How are firms assessed against these criteria?
- ? What best practices have you seen for making the transition between audit firms effective and efficient? What can the outgoing auditor, the incoming auditor and the company do? How should the board and the audit committee handle the process?
- ? What impact would an increase in tendering have on audit fees? What impact would lower fees have on audit quality? How should the audit committee ensure there is a quality audit for the protection of shareholders?