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Audit Tendering in the UK: A Review of Stakeholders' Views

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Abstract

Despite the importance of the ongoing debate on audit tendering and its possible implications for the audit profession including audit market structure, audit quality, and auditor independence, there is an apparent lack of research into this area. Using content analysis, this study reports the results of an examination of the comment letters sent to the UK Financial Reporting Council (FRC) in response to its consultation document on the 2012 revisions of the UK Corporate Governance Code. The results indicate a general support for the FRC's proposals with a number of key concerns related to audit quality, audit cost and auditor independence. There is also clear conflict of interests among some groups such as audit firms and companies on one side and institutional investors on the other side. There is evidence of conflict of interest between Big 4 and non-Big 4 audit firms. The findings could influence future revisions of the Code with regard to tendering and enhance policy makers' understanding of the position taken by each group of stakeholder.

Keywords: Audit tendering; Audit change; Independence; Audit quality; Corporate governance; Content analysis; FRC

INTRODUCTION

Audit tendering is a process through which a company puts its audit engagement to an open tender on a periodic basis (FRC 2013). It generally aims at increasing the public confidence in the auditing profession and to increase the competitiveness within the audit market, thus enabling companies to achieve the best possible audit services in terms of cost and quality, and audit firms to innovate in the way audits are conducted (FRC 2013).

Traditionally, companies change their auditors relatively infrequently, and when it occurred, it was due to several reasons such as: auditor's fees; poor audit service; change in the company's leadership; change in '*chemistry of the relationship*' between management and the audit firm (Beattie and Fearnley 1998a, 261); change within the company's structure (e.g. merger, acquisition), lack of auditor's professionalism and competency (Beattie and Fearnley 1998b); and/or disagreement between the company and the audit firm on particular accounting treatment(s) (FRC 2013). However, the change of auditor was rarely seen as a mark of, for example: good governance (i.e. independence and objectivity), testing the audit market on the quality/price of the audit service, and/or stimulating the incumbent audit firm (FRC 2013).

The UK's Financial Reporting Council (FRC), the independent regulator responsible for promoting high quality corporate governance and reporting, believes that "... *[audit] tendering provides an effective way by which companies can examine whether they have the best auditor available ...*" (FRC 2013, 1). As such, in April 2012, the FRC released for public comment a consultation document "Revisions to the UK Corporate Governance Code and Guidance on Audit Committees", among the issues covered was a proposal for audit tendering. In October 2012, in the updated UK Corporate Governance Code, the FRC introduced a new provision on audit tendering requiring FTSE 350 companies, on a comply or explain basis, to put their audit engagement out to tender every ten years.

A review of the literature reveals a lack of prior research on audit tendering with exception to the work of Beattie and Fearnley (1994, 1995, 1998a, b), who mainly focused on exploring the views of only one stakeholder group (i.e. management) regarding the audit tendering. Thus, this study attempts to fill an apparent gap in the literature by contrasting the different and conflicting views of various stakeholder groups on audit tendering. More specifically, the present study reports the results of a content analysis of the comment letters written in response to the FRC consultation document, and attempts to address the following research questions:

- (i) What are the main audit tendering proposals made by the FRC?
- (ii) What is the level of support/opposition for each of these proposals? and
- (iii) What are the positions of the different stakeholder groups and their arguments to support or oppose the FRC's proposals?

The content analysis results indicate a general support for the FRC proposals with a number of concerns expressed by different groups of stakeholders. The main concerns are related to audit quality, audit cost and auditor independence. There is also clear conflict of interest among some groups such as audit firms and companies on one side and investor relation on another side. There is evidence of conflict of interest between Big 4 and non-Big 4 audit firms. This study contributes to the literature on audit tendering by enhancing the understanding of the risks/opportunities that the proposed changes would expose/create as perceived by different stakeholder groups, and the motivations of these groups, and how they would probably react to any future policy changes on tendering. The findings could be a source of guidance for the FRC and potentially influence future revisions of the UK Corporate Governance Code, with regard to tendering, and should contribute towards enhancing policy makers' understanding of the position taken by

each group of stakeholder. To the best of our knowledge, this study is the first that takes advantage of the comment letters made available online by the FRC and fills a gap in the literature.

The next two sections provide a brief background of the UK corporate governance including the proposals made for audit tendering, and a review of the main issues that would be more likely associated with audit tendering. The research design and results are presented in the following sections. The paper concludes with implications of the findings and concluding remarks.

BACKGROUND: THE UK CORPORATE GOVERNANCE CODE

Corporate governance rules have been tightened all over the world owing to the numerous corporate scandals (e.g. Enron and WorldCom), resulting in several implications for the auditing profession starting with the appointment of the external auditor. In the UK, the Cadbury Report was published in 1992 and covered a number of issues related to corporate management (board formation), internal control, and the formation of an audit committee. In 1995, the Greenbury Report focused on executive compensation and recommended the formation of a remuneration committee. The Greenbury's Report was reviewed in 1998 by a committee led by Sir Ronald Hampel that recommend the consolidation of the two previous reports (Cadbury and Greenbury) into a Combined Code. After the financial crisis of 2008, another review was conducted, the Walker Review, that focused on the banking industry. Two years later, the FRC published the Stewardship Code and updated the Combined Code that started to be known as the UK Corporate Governance Code (hereafter, referred to as *the Code*).

The Code has been subject to a two-year revision cycle and in 2012 the proposed revisions included, among other issues, suggestions to enhance the audit quality and effectiveness that deals with the threats associated with long audit tenures. The suggestion aimed at introducing a number of adjustments to Provision C.3.7 of the Code under which FTSE 350 companies would be required to put their external audit contract out to tender at least every 10 years. The suggestions also included an addition to the same

provision to require companies to “disclose the length of tenure of the current audit firm and when they last put the external audit contract out to tender.” The FRC noted that although there was already a recommendation in the Guidance on Audit Committees to this effect, only one-third of companies disclosed such information. Thus, the FRC proposed to incorporate this disclosure as a requirement in the Code. The FRC amended the Code and the Guidance on Audit Committees, with effect from 1 October 2012.

The Code was subject to another revision in 2014 when the FRC published another consultation document; however it did not cover tendering. The FRC decided to wait for the final Orders of the Competition Commission (now the Competition and Markets Authority) on audit contract tenders, which in turn decided to postpone the finalization of its Orders to accommodate the revised EU Audit Directive and the new EU Regulation on the audit of public interest entities, thus avoiding any potential overlap. It is expected that the issue will be revisited in the 2016 revision of the Code.

AUDIT CHANGE: MAIN ISSUES RELATED

There is an apparent lack of prior research focusing on audit tendering. Thus, this section attempts to establish a grounding to support the discussion of content analysis results. Assuming that audit tendering would lead to a change either in the audit firm, the way the audit is conducted, or both, this section outlines main audit related issues associated with audit change (i.e. rotation), namely: audit quality, audit fees (cost savings), audit market structure, and audit independence.

Audit Quality

Prior studies on audit rotation have contradictory findings on the possible impact of audit rotation on the audit quality. In Italy, Healey and Kim (2003) conclude that audit rotation increases the reliability of the audit regulatory system. In Australia, Lai and Cheuk (2005) found evidence that audit firms' rotation is

more effective than audit partners' rotation in enhancing the quality of audit reports. This was supported by recent findings of Chang, Liu and Forgiione (2014) in Taiwan, and Lennox, Wu and Zhang (2014) in China, that mandatory audit rotation affects audit quality and audit behaviour of audit partners as well. These findings are based on the assumption that the old audit firm/partner has the motivation to clean up the financial statements before departure and the new audit firm/partner seek higher audit quality when they are assigned the new audit. Nevertheless, other studies found negative or no associations between audit firm rotation and audit quality. For example, investigating the effect of audit partner rotation on audit quality, Jenkins and Vermeer (2013, 75) provide a review of the literature on the issue and reported that the “*collective evidence is inconclusive at best*” with regard to the impact of audit rotation on audit quality. Jackson, Moldrich, and Roebuck (2008, 420) reported that audit firm tenure does not negatively affect audit quality and that “*there are minimal, if any, benefits of mandatory audit firm rotation.*”

Audit Fees (Cost Savings)

Early evidence of price cutting policy along with auditor changes has been noticed in the US (Simon and Francis 1988), and the UK ([Beattie and Fearnley 1994](#)). On one hand, a trade-off between the possibility of failing the uncertain quality threshold and the need to maintain costs, down compared to other competitors, is might still exist. On the other hand, although competitive tendering might seem to deliver cost savings, the extent of such savings is unclear over long-term period (Steane and Walker 2000, Boon, Crowe, McKinnon, and Ross 2005). Indeed, earlier literature has delivered mixed and inconclusive results concerning competitive audit tendering and its relationship to cost savings and audit quality. Given that prior research (e.g. Palmrose 1986, Deis and Giroux 1996) has documented a significant positive relationship between audit fees and audit quality, concern had been raised about the audit quality under the pressure of audit fees cut policy. For example, Beattie and Fearnley (1998a) pointed out that audit tendering and the common resultant phenomenon of auditor change resulted in a significant fee decrease,

particularly in the first year of change in the UK. [Boon et al. \(2005\)](#) documented a relatively large audit fee decrease subsequent to the introduction of compulsory audit tendering in Australia. This reduction or discount in the initial engagement year is consistent with low balling policy predicted by [DeAngelo \(1981\)](#), where the audit fees of the new appointed auditor is more likely to go up to their normal level after a few years from the initial engagement ([Simon and Francis 1988](#)). In contrast, [Kwon, Lim and Simnett, \(2014\)](#) observed an increase in audit fees, in South Korea, for those companies that mandatorily change auditors compared.

Audit Market Structure

During the last three decades, there had been an apparent increase in the number of mergers, as the number of big audit firms went down from eight in 1980th to four in 2002. This was mainly attributed to the highly competitive environment and the ability to offer marginal cost reductions for large clients. However, by the early of 2000s, audit market competition was brought back to the light under the significant increase in market concentration, and the subsequent audit tenure mainly caused by the merger events. [Beattie, Goodacre and Fearnley \(2003\)](#) reported dramatic increase in the level of auditor concentration in the UK listed company market (immediately prior to Arthur Andersen's demise), as the Big 4 held 90% of the market rising to 96 % with the collapse of Arthur Andersen.

It can be claimed that audit firm rotation might induce an adjustment in the structure of the audit market and increase the possibility of small firms entering the market. This is probably the reason that made Spain and Israel think to apply mandatory firm rotation to give the local firms a chance to compete. However, eventually Spain decided to discontinue mandatory rotation in 1995 after only seven years of its adoption ([Catanach and Walker 1999](#)). Moreover, in 1992, the Canadian government also eliminated a mandatory firm rotation provision for banking ([Catanach and Walker, 1999](#)). These findings may give the

impression that audit change did not achieve the required purpose to change the audit market structure and some may consider that this is evidence for the ineffectiveness of audit change regulations.

Auditor Independence

The threat of long audit tenure and its impact on auditor's independence has been investigated in a number of studies (e.g. [Firth 1980](#), [1981](#), [Shockley 1981](#), [DeAngelo 1981](#), Geiger and Raghunandan 2002, Gul, Jaggi, and Krishnan 2007, Manry, Mock, and Turner 2008, APB 2008). In an attempt to minimise such threat, audit change (i.e. firm and partner rotations) was recommended. However, mixed evidence was found in previous studies. Mandatory audit firm rotation may enhance auditor's independence and in turn audit quality, as it may enable a fresh look on client's business (ICAEW 2002, Arel, Brody, and Pany 2005, Brody and Moscovice 1998, Ramsay 2001, Jennings, Pany, and Reckers 2006). However, other studies (e.g. Tepalagul and Lin 2015, Shockley 1981, Hussey and Lan 2001, Knechel and Vanstraelen 2007) concluded that the auditor tenure has no impact on auditor's independence. For example, Ruiz-Barbadillo, Gomez-Aguilar and Carrera (2009, 132) found that mandatory rotation "*not only fails to enhance auditor independence, but may in fact harm independence*". Furthermore, St. Pierre and Anderson (1984) found that auditor's independence might be affected by auditor change as it is likely for them, in the early years of the engagement, to be considered as inexperienced with their client and need more time to develop their understanding of the client's business. However, [Gietzmann and Sen \(2002\)](#) argue that whether auditor's change can improve auditor independence or not depends on characteristics of audit market structure, and economic dependence of auditor on the individual client. They concluded that auditor rotation is costly, however in those markets that characterized by few large clients (thin markets), the benefits of improved incentives for independence can outweigh the cost. But it may lead to additional unnecessary cost in case of sufficiently developed audit market.

RESEARCH DESIGN

A total of 70 comment letters were sent to the FRC in response to the consultation document, which were made available on the FRC's website. Nine of these letters did not include any comments about tendering, resulting in 61 letters commenting on audit tendering. In order to highlight the different stakeholder groups' views, comment letters were categorised to eight groups of stakeholders based on their business core and/or Interests (see Table 1). These are: auditing firms (i.e. providers of the service); companies (i.e. audit clients); professional bodies (i.e. the profession's governors); and institutional investors (i.e. users of the audited disclosed information). The remaining groups were categorized as they described themselves (e.g. in the comment letters or on their websites).

Table 1 shows a breakdown of the letters by stakeholder group and the average number of words per group.² The number of words, in commenting on audit tendering, ranged between 21 and 2,972 with an overall average of 442 words. It is not surprising to notice the relatively high average (1,155 words) for the auditing firms group compared to any other group.

INSERT TABLE 1 HERE

The FRC consultation document raised a number of issues starting with agreement/disagreement with tendering in principle. The document also asked for views on other issues including whether it should be mandatory or on *comply or explain* basis, tendering frequency, transitional arrangements, and previous year disclosure. Table 2 provides a brief explanation of each of these issues.

² Table 1 shows the average number of words based on the 61 letters that included comments on tendering. The number of words includes only the comments made by each respondent excluding any quotations taken from the FRC's Consultation Document.

INSERT TABLE 2 HERE

Manual content analysis technique was applied into the stakeholders' views written in the 61 comment letters to induce meaningful inferences. As a technique, its core is to organize text to specific groups that can be used to extract patterns or views of different entities or to follow trends over time ([Krippendorff 2012](#)). There are two approaches of content analysis, form-oriented analysis that focused on word counts and meaning-oriented analysis that focused on the meaning behind the words (Yen, Hirst, and Hopkins 2007). Given the purpose of this study, the latter was adopted to analyse the responses to the FRC's consultation document about audit tendering proposals. The analysis was undertaken by two researchers and discussions were held whenever a difference in the coding existed. A third opinion was obtained in a number of occasions.

Throughout the coding process, an approach was adopted under which the comments were deemed supportive of a proposal if it was either explicitly or implicitly expressed. This also includes "not opposing" the proposal in a number of cases. Comments against the proposals were considered so, if they were expressed explicitly in the letters or, in very few cases, they were extremely negative and cautious of the negative consequences of the proposals. For example, Ernst & Young did not explicitly oppose the proposal, but provided a number of alternatives in a dedicated appendix to their letter and warned of the increased risk "*that auditor independence could be impaired*" and that it could "*create additional market concentration and impact audit quality*" (Ernst & Young). If we could not infer from the comments that they were supportive or not, *No Comment* was recorded for the particular respondent/proposal. To illustrate, if the respondent expressed that they are supportive of the FRC's proposals with no objection to any single proposal made by the FRC, this case would be coded as supportive to all of the proposals as listed in Table 2 above. In other cases, the respondent would support the "intent" but does not comment positively or negatively on any details; for example: "*We support the intent of the proposed revisions.*"

However we are concerned about what effect some of them would have in practice” (ACCA). This was coded as supportive of P1 and NO Comment for P2, P3, P4 and P5. In few cases, the respondent would express concerns regarding a proposal but without explicitly objecting to it; such cases were considered as supporting the proposal. For example, “There is a danger that the “requirement” for re-tendering at least every ten years, or more certainly, ...” (Capita Registrars).

Although only 70 respondents (with only 61 on audit tendering) commented on the FRC proposals, the responses widely represent the views of the most influential interested parties in the market. Many of these letters come from professional associations that represent thousands of members, the Big 4 auditing firms, big companies such as Barclays, BT, Tesco, and Vodafone, and major accounting and non-accounting professional bodies (including ACCA, ICAEW, CIMA, and CFA), in addition to major institutional investors (such as BlackRock, Aviva Investors, Hermes Equity Ownership Services and a number of pension funds).³

FINDINGS

General Observations

Table 3 shows overall indications regarding the tendering proposals made in the consultation document. It reveals that 83.6% of the respondents, across all groups, support tendering in principle; companies should put the external audit contract out to tender every a specific number of years. Only 14.8% opposed the proposal, while the rest (1.6%) did not express an opinion on tendering in their response to the FRC’s consultation document. Further, the level of support varied across the groups with institutional investors,

³ However, it is surprising to find out that only 15 companies of the FTSE 350 responded to the consultation document. The external auditors for these firms are all Big 4 (PWC 7, KPMG 4, Deloitte 3 and Ernst & Young 1).

professional bodies, advisory and consultancy firms showing the highest level (100%); see Table 4 (Panel A).

INSERT TABLE 3 HERE

On the issue of having the tender process on a ‘*comply or explain*’ basis, the results show that 63.9% supported the proposal with 6.6% against and 29.5% making no comments. The FRC made it clear that the tendering process does not mean mandatory rotation and companies only need (on a *comply or explain* basis) to put their audit contract out to tender every 10 years. Only 36.1% supported the 10-year tendering frequency and 37.7% were against the proposal. A total of 8 respondents suggested a longer frequency of 15 years, while 6 respondents suggested a shorter frequency of 5 years, and 9 did not suggest a different frequency.

The results also show that 59% of respondents support the transitional arrangements proposed by the FRC to avoid unexpected/undesired consequences for direct implementation of tendering. The proposal of “*Previous Year Disclosure*” was the most issue with no comments (49.2%). The high percentage of no comment for some of the proposals could be explained by the fact that the responses were to the revisions to the Code and not focused only on tendering. Other possible explanations include implicit acceptance of the proposals or lack of interest in the issues proposed. For example, an institutional investor, National Employment Saving Trust, commented: “*we provide comments where we feel revisions can be further improved or expanded. Where we do not comment on proposed revisions the FRC should assume we are either in agreement with these changes or have actively decided not to comment at this stage.*”

The rest of this section provides a detailed discussion of the findings for each proposal as Table 4 demonstrates.

INSERT TABLE 4 HERE

Tendering

Table 4 (Panel A) shows a breakdown of the responses by stakeholder group to the principle of tendering (i.e. FTSE 350 companies should put the external audit contract out to tender at least once every ten years). The level of support for audit tendering varied across the stakeholder groups. All institutional investors, professional bodies, advisory and consultancy firms expressed their support for tendering. None of the major stakeholder groups, with exception to auditing firms (44%) and companies (20%), opposed tendering.⁴ Five out of nine audit firms supported tendering, albeit expressing a number of concerns. All the Big 4 did not support the proposal citing threats to audit quality and auditor independence with some providing alternative solutions.

Table 5 presents a breakdown of the results for the auditing firms group by size (Big 4 vs. non-Big 4) that shed some light on the positions of these firms towards the potential impact of tendering on their business. The results indicate that only non-Big 4 audit firms supported tendering. The main arguments made by the biggest opposing group, Big 4 firms, against tendering included potential negative impacts of tendering on audit quality and auditor independence, and increased costs to both auditors and clients. In their response, Deloitte suggest that the proposals *“are aimed at addressing the perceptions of auditor independence rather than improving audit quality. Not one study links firm rotation with audit quality or market expansion.”* They add: *“We believe that, on balance, tendering every ten years even on a comply or explain basis is not in the best interests of companies nor will it accomplish the audit quality objectives.”*

⁴The Private Capacity group represents the views of individuals and was included in our analysis for the record, but its weight is incomparable with other groups; thus, it will not be stressed in the rest of the paper.

Another Big 4 firm, Ernst & Young expressed a similar view: *“We do believe that mandatory tendering could create additional market concentration and have a negative impact on audit quality.”*

INSERT TABLE 5 HERE

The consultation process gave an opportunity for non-Big 4 firms to defend their interests as Kingston Smith responded: *“We would recommend that the FRC consider mandating that the tender process includes at least one non Big Four firm.”* Mazars echoed by calling for audit committees to *“include firms other than the dominant four players in the tendering process and to report both on those invited to tender and those which were shortlisted.”*

Expressing similar concern of the potential negative impact of tendering on audit quality, one of the three companies that opposed tendering, Associated British Foods, gave three reasons:

- *lack of familiarity with client systems and processes together with the distraction of increased tendering*
- *incumbent auditors may be inclined to be more accommodating during what could be their final audit in an attempt to influence the decision on whether to reappoint and thereby jeopardise their independence*
- *tendency for audit firms, and particularly their most capable staff, to focus on winning tenders at the expense of servicing their existing audit clients, with a consequent detrimental effect on the quality of the audit*

However, as discussed earlier in section 3.1, a number of studies have found evidence that contradicts the above claims (assuming that the tendering process would lead to a change; i.e. audit firm rotation). For example, Healey and Kim (2003) in Italy, Lai and Cheuk (2005) in Australia argued that audit rotation would enhance audit quality. Nevertheless, other studies found negative or no associations between audit

firms' rotation and audit quality and independence; for example, Jackson, Moldrich, and Roebuck (Jackson, Moldrich, and Roebuck 2008) and Jenkins and Vermeer (2013).

As for auditor independence, Ernst & Young raised a concern, indicating that: *“Mandatory tendering increases the risks that auditor independence could be impaired. It gives auditors an additional incentive to want to please management because it is a certainty that a tender will take place within a defined window.”* The same concern was flagged by Associated British Foods, commenting that *“... incumbent auditors may be inclined to be more accommodating during what could be their final audit in an attempt to influence the decision on whether to reappoint and thereby jeopardise their independence.”* One institutional investor, RPMI Railpen Investments, thought that neither tendering nor partner rotation are enough and called for mandatory audit rotation claiming that *“An upper limit to firm tenure is vital to auditor accountability in our view and is actually quite widespread in the UK public sector.”* Their main argument is that incumbent auditors will know that their work will be reviewed by the new auditors and thus will be more likely to challenge management if needed.

Other concerns were emphasized regarding the time and the need to plan for the potential change and its effects on non-audit activities. For example, BT plc's letter highlighted that *“companies will have to plan the potential change of auditor sufficiently in advance such that a new incumbent (if not the current incumbent) will have enough time to cease and withdraw from its non-audit activities, to allow it to attain “independent” status for audit purposes.”* The cost of the tendering process and the possibility that tendering will be another box-ticking burden were also mentioned as reasons against tendering. Some suggested that tendering should take place when needed; i.e. when the company is not satisfied with the current auditor's performance, for instance.

Regardless of the concerns mentioned above, mainly by Big 4 firms and 3 companies, the data in Table 4 (Panel A) indicate a majority support for tendering. All institutional investors support the proposal and

this finding, perhaps, reflects their doubts of the long-term relationship between auditors and companies and its related familiarity threats. The main argument for supporting the proposal was related to gaining the shareholders' trust, claiming that tendering would enhance audit quality. In addition, six professional bodies (both accounting and non-accounting) that commented on the proposal supported tendering. Only two professional bodies did not make any comments and it is interesting to note that the Institute of Internal Auditors (IIA) to be one of those. Similarly, all lobbyist associations, that made a comment (10), supported the proposal with no opposition, as another respondent not commenting on the issue.

Comply or Explain (Scope)

This proposal requires companies to comply with the UK Corporate Governance code provisions with regard to tendering or explain reasons for non-compliance. It entails that audit committees are in the best position to assess the quality of the audit service provided by current auditors whether there is a need to tender the audit contract. However, to increase the competition in the audit market, the FRC stressed that companies should put out the audit contract to tender every 10 years to make sure that they get the best-valued audit service in terms of quality and price. Companies have to comply with this, otherwise they need to explain why they prefer to delay the tendering process; under which case, companies will have to provide logical reasons. This proposal should enhance the transparency in the company's disclosures by providing more information to shareholders.

Overall, 63.9% of the respondents (see Table 4, Panel B) support the '*comply or explain*' basis. However, disregarding the 18 respondents that did not comment on this proposal, it appears that the grand majority of respondents made a comment supported it; a total of 39 (91%) against only 4 (9%) respondents that opposed the proposal supporting mandatory tendering instead. The responses emphasised a number of factors for supporting the '*comply or explain*' basis such as audit quality, time and cost. Another factor was the role of the audit committee as the most relevant party to take a tendering decision as they are in

the best position to know when and why companies need to change their auditors. On the other hand supporters of mandatory tendering claimed that it would “*encourage greater competition, strengthen auditor independence and improve audit quality*”, as echoed by RPMI Railpen Investments.

The majority of respondents see mandatory tendering as un-needed regulation. One Big 4 (Deloitte) envisages that it could lead to a stance where the 10-year tendering frequency seen as a fixed term for the auditor and probably decreasing the chances of auditor change in the intervening period. Another Big 4 (Ernst & Young) advocates that mandatory tendering “*increases the risks that auditor independence could be impaired. It gives auditors an additional incentive to want to please management because it is a certainty that a tender will take place within a defined window.*” On the corporate side, BT plc sees that mandatory tendering “*would inevitably result in a reduction in audit quality in the initial and final years of the appointment and an increase to audit fees.*” The same concern recited by Unilever plc: “*A blanket mandating of audit tenders would add significant time and cost, with no commensurate benefit to shareholders and also have the unintended consequence of poor quality audits during the transition years.*”

Timing is also noted as crucial factor for supporting the ‘*comply or explain*’ basis as it “*enables the tender to take place at a time that’s right for the business, and not during periods of significant change or a time that is not in the company’s best interests*”, as commented by Ernst & Young.

All audit firms and companies that responded to the consultation document opposed having ‘mandatory’ tendering. This could be seen as a desire to avoid regulatory influence on the way companies manage their business. In its response, BT plc indicated that: “*There may be circumstances when a tender may not be an appropriate course of action (for example if a company is undertaking a significant transaction) and therefore the frequency of audit tendering should remain a decision for the audit committee.*”

Support for mandatory tendering, on the other hand, was expressed by a number of institutional investors (2), lobbyists (1), and private capacity (1). Supporters of mandatory tendering cited the following factors: increased competition and concentration in the audit market, improved audit quality and auditors' independence, and the provision of a fresh pair of eyes. However, a counter argument provided by auditors is that fresh pair of eyes is already provided by the current partner's rotation policy and there is no need to firm's rotation that may result from tendering.

On the other hand, a number of institutional investors believe that firm's rotation will avoid the following issues that cannot be prevented by partner's rotation. One institutional investor believes that: "*Auditors becoming 'captured' by their own historical judgments. There is a real risk of incumbent auditors being unwilling to challenge their own past judgments, where such an act would be likely to inflict reputational damage and – where restatements result – potential legal liabilities*" (Pensions & Investment Research Consultants' response); further adding that: "*Where an audit firm knows it will be replaced, it will be incentivized to maintain skepticism as its judgments will be reviewed in detail by the incoming auditor.*"

Tendering Frequency

Under this proposal, companies should put the audit contract out to tender once every 10 years, as a maximum period. The results in Table 4 (Panel C) indicate that the respondents are almost divided equally on this proposal, with 36.1% supporting the proposal and 37.7% opposing it (and 26.2% not commenting). Out of the 23 respondents that opposed the proposal, eight suggested a longer frequency of 15 years, and six suggested a shorter frequency of five years. The other nine did not suggest an alternative. Three of the Big 4 opposed the proposal, with Ernst & Young making no comment. The three audit firms that supported the proposal were all non-Big 4. Unsurprisingly, this is another situation that highlights the different positions taking by these two groups reflecting their own interest.

One of the Big 4 firms, Deloitte, believe that *“tendering every ten years even on a comply or explain basis is not in the best interests of companies nor will it accomplish the audit quality.”* They further suggest instead a longer period of 14 years (the equivalent of two 7-year partner rotation periods) as it *“would be more appropriate than the proposed ten year period or indeed 15 years being 3 existing UK partner rotation periods.”* Another Big 4, KPMG, believe that the ten years period will not be suitable for all companies and in particular for the larger ones as they comment: *“in particular we think that considering changing auditors every 10 years for the larger, more complex companies will not necessarily strike the right balance ...”* The ten years period is also seen by KPMG as a threat to the role of the continual review of the external audit by the audit committee as the periodical tendering process will be seen as *“the only way that the audit committee can adequately assess the quality of different audit firms and/or that there is in fact something inherently wrong with long tenure. We do not agree with either proposition.”*

Emphasising increased costs and disruptions to the audit process, Price Waterhouse Coopers opposed the proposal and suggested a longer *“more realistic period”* of 15 years or three audit partner rotation cycles. They see that *“setting an expectation that a tender should take place every ten years, allowing only two audit partner rotation cycles, may represent an unnecessary burden on companies and therefore on shareholders.”*

On the other hand, a non-Big 4 audit firm, Grant Thornton, support the 10-year frequency as it is *“aligned with investors views”*, with no further comments on how this alignment measured or can be achieved. Another non-Big 4, Mazars, sees that *“The maximum 10 year period between tenders is within, albeit at the upper end of, what many would consider to be a reasonable period.”* Similar to Grant Thornton, no comments were made to support their claim of what constitutes a reasonable period or whom is/are referenced to by the word “many”.

Transitional Arrangements

The FRC proposed a set of transitional arrangements *“to ensure that the introduction of tendering is phased over a suitable period.”* Two factors were considered regarding to the timing of tenders: the audit engagement partner cycle and the length of time since the audit contract was put out to tender. Thus, the FRC proposed that tenders should take place in a time that would not cause any disruptions to the existing audit engagement partner cycle. In addition, the FRC proposed, *“where a company has put the audit contract out to tender in or after 2000, the tender process could be deferred until the latter stages of the incoming audit engagement partner’s term (in other words, for a further five years).”* The FRC estimated that the these proposals would lead to deferring the audit contract tendering date for a large number of FTSE 100 until 2018 or later.

Table 4 (Panel D) indicates that the majority of respondents that made a comment on this proposal supported it (36 out of 39). About 36.1% of the respondents did not make a comment on the proposal and this could be explained as an implicit acceptance or as lack of interest in the issue. The three respondents that opposed the proposal belonged to the audit firms, consultancy and institutional investors groups.

Price Waterhouse Coopers, a Big 4 firm, expressed their concerns that the *“proposed transitional arrangements underestimate the impact of the changes since the table includes only FTSE 100 companies.”* They also thought that the tendering process might lead to *“significant upheaval and cost”* for both audit firms and companies because of tendering in general and *“around any transition between firms”* in particular. They estimated a total of 35 major tender processes every year assuming 10-year cycle. The audit firm did not suggest any alternatives other than extending the tendering frequency from 10 to 15 years. A consultancy firm, Manalyze Associates, had similar concerns but for different reasons. They thought the arrangements were not sufficient compared to tenders of commercial contracts as there is no specification of *“a time-limit before retendering and period evaluations of performance based upon*

agreed Key Performance Indicators.” BlackRock, an institutional investor, were skeptical that the transitional arrangements “would only allow a phased in application of this requirement and give more time to companies to comply with it but will not mitigate the risks the audit firms’ rotation entails for the companies.”

Previous Year Disclosure

In addition to the proposed revisions to Section C of the Code, the FRC has made a number of recommendations to the Guidance on Audit Committees. A tendering related proposal recommends: *“companies [have to] indicate their intention to put the audit out to tender in the previous annual report.”* As Table 4 (Panel E) demonstrates, 49.2% of the respondents did not make a comment on this proposal. However, the majority of respondents that made a comment supported it (24 out of 31). Similar to the transitional arrangements proposal, the lack of comments could be due to implicit acceptance or as lack of interest in the issue. A total of 7 respondents opposed the proposal, the majority of which belong to the lobbyist group (3) and companies (2).

One of the main reasons for opposing this proposal, as expressed by a number of respondents, was its impracticality as the circumstances under which a decision to put the contract out to tender might change. Also, some believed that there are other means to disclose such information. KPMG, a Big 4 audit firm, commented: *“we do not believe it will always be practical or desirable to disclose in the annual report the company’s intention to carry out an audit tender in the following year.”* One of the companies, Associated British Foods, opposed the proposal highlighting fears related to auditor independence. They thought that *“incumbent auditors may be inclined to be more accommodating during what could be their final audit in an attempt to influence the decision on whether to reappoint and thereby jeopardise their independence.”* Another company, Smith & Nephew plc, referred to the possibility of the need to: *“part the way through a year”* with the incumbent auditor and, accordingly, the need to put the audit contract to tender. They

added that this proposal “*would not make sense*” as it requires delaying the tender for another year as the shareholders would not have been made aware of the company’s intentions. They also referred to the possibility of a need to postpone a previously announced tender. Similar concern was raised by CBI and the Hundred Group of Finance Directors. CBI welcome that “*this is part of the guidance and not a more rigid requirement*” (not part of the Code). The Law Society of England and Wales saw no reason to set out the intention in the annual report, and suggested the company to make an announcement instead: “*Requiring the announcement to be in the annual report could possibly delay the company’s ability to commence the tender, if the company decides to do so during the course of the year.*”

In response, the FRC changed this requirement and companies will not be required to disclose their intention in the previous year’s annual report. Under the new guidance a company “*should announce its intention in advance of the commencement of the tendering process*” (section 4.23, Guidance on Audit Committees). The FRC did not determine how companies should make this announcement nor when, and left the decision for the companies (mainly the audit committee) to make.

DISCUSSION AND IMPLICATIONS

In September 2012, the FRC published the revised version of the Code and the Guidance on Audit Committees, which included the following on audit tendering:

The Code *FTSE 350 companies should put the external audit contract out to tender at least every ten years.*

The Guidance on Audit Committees *FTSE 350 companies should put the audit services contract out to tender at least once every ten years, to enable the audit committee to compare the quality and effectiveness of the services provided by the incumbent auditor with those of other audit firms. So that there is time to undertake an effective tendering process, and to allow shareholders to provide input to the process should they wish, the company should announce its intention in advance of the commencement of the tendering process. (Section 4.23)*

The audit committee section of the annual report should include an explanation of how the committee has assessed the effectiveness of the external audit process and of the approach taken to the appointment or reappointment of the external auditor, in order that shareholders can understand why it recommended either to re-appoint or change the auditors. It should also include information on the length of tenure of the current audit firm, when a tender was last conducted, and any contractual obligations that acted to restrict the audit committee's choice of external auditors. (Section 4.26)

The above provisions show that the original proposals have been incorporated into the Code and the Guidance on Audit Committee with few exceptions resulting from the consultation process. First, companies are not required to express their intentions of tendering the audit contract in the previous annual report; previous year disclosure proposal. Although this proposal did not have significant opposition number-wise, practical reasons were cited and the FRC took them into consideration and accordingly did not make this proposal as a requirement in the 2012 version of the Code. Second, the FRC suggestion to amend provision C.3.7 of the Code with a requirement that companies “*disclose the length of tenure of the current audit firm and when they last put the external audit contract out to tender*” did not get enough support to be part of the Code and this is now part of the Guidance on Audit Committees instead.

The highest level of opposition was on the 10-year tendering frequency (37.7%); however, as discussed earlier, the opposition did not push towards a specific direction. Some respondents called for a shorter frequency while others called for a longer one. In other words, there was no significant pressure from any group(s) that could have prompted the FRC to further consult or even make a change to the proposals.

Although the FRC has made it clear that tendering will be on a ‘*comply or explain*’ basis, it did not set any time frames for how long companies can continue explaining without putting the audit contract out to tender. This is perhaps the reason for Ernst & Young to refer to the proposal as ‘mandatory tendering’ across their response. Prior to issuing the Code (2012 version) companies had the option to put the

contract to tender. However, the tendering proposal, in essence, makes it mandatory around the end of the 10-year cycle.

The major concerns expressed by the respondents were related to audit quality, auditor independence and audit costs. The complexity, size, and diversity of business were the main reasons to support threats to audit quality and costs. The pressure by management on auditors towards the end of the tendering cycle was the main reason behind the threat to auditors' independence as they would try to be more accommodating. Evidence from previous research on audit quality is inconclusive with regard to each of these claims. More research is called for over the next few years after the adoption of the Code to investigate the effects of tendering; however, this may require a cycle or two to monitor the impacts of tendering on above variables (quality, independence and cost).

The comments reflect the main motivations for each group. Institutional investors major motivation is the potential effects on long-term relationships between companies and audit firms. Albeit raising concerns to audit quality, it can be claimed that Big 4 firms are protecting their market share. On the other hand, non-Big 4 firms stressed the need for a provision to include them in future tenders, in an attempt to increase their market share. The companies seemed to stress the impact of tendering on the smooth running of their operations and the potential increase in audit costs. The professional bodies did not oppose any proposals.

Although all the major stakeholders have participated in the consultation process, a total of 70 letters in response to such a major issues could be seen as proportionally low. As mentioned earlier, only 15 companies responded to the consultation. Perhaps the public consultation process should be reconsidered in any future consultations to involve more stakeholders.

The Code was subject to another revision in 2014 that did not include any revisions related to tendering. The FRC decided to wait for the final Orders of the Competition and Markets Authority that in turn

decided to postpone its Orders to accommodate for the revised EU Audit Regulation and Directive. The EU audit reform came into effect in June 2014 although many of its features will not be effective until June 2016. The UK Department for Business Innovation & Skills (BIS) and the FRC issued discussion papers in December 2014 seeking opinions on alternatives for the implementation of the EU audit reform. Under the new EU legislation, companies would be required to rotate their auditor every ten years, but this can be extended to 20 years if there is a competitive tender; however, no specific time frame was identified within which the audit contract should be put out to tender. The UK BIS proposed extending the maximum audit firm tenure to 20 years, and for companies to declare their intention of tendering in the Directors' Report. These consultations will shape the future of the audit profession in the UK, including tendering, and provides opportunities for future research.

CONCLUSION, LIMITATIONS, AND FUTURE RESEARCH

This paper reports the results of a detailed review, using content analysis, of the comment letters written in response to the FRC 2012 Consultation Document on a number of revisions of the UK Corporate Governance Code. The review is limited to the audit tendering proposals in the Code and the Guidance on Audit Committees.

The main proposals are that tendering will be on a '*comply or explain*' basis at least every 10 years. The FRC has also proposed a number of transitional arrangements and these were published on its website. The only change made to the proposals was the previous year disclosure. Under the original proposal, companies would have to declare their intentions of putting the audit contract to tender in the previous annual report. However, as a result of the consultation process, companies will not be required to disclose their intention in the previous year's annual report. The FRC has decided not to include such requirement in the Code and recommended in the Guidance that companies should declare their intention in advance, without dictating a time frame or the media. The level of support/opposition to the proposals have varied

across the different groups with Big 4 firms and few companies showing the biggest opposition raising concerns related audit quality, cost and auditor independence. Similar concerns were raised by the institutional investors group, albeit in support of the proposals.

Previous studies on tendering have utilised interviews to explore the phenomenon, including its motivation and to understand the auditor change process. These studies usually focused on the views of two stakeholder groups; companies' management and audit firms. This study covers the views of almost all stakeholder groups and contributes to the literature on tendering by documenting the positions of these stakeholders. The study also documents the different positions, albeit expected, of Big 4 against non-Big 4 firms. This, perhaps, provides an example of how the first group are trying to protect their market share (i.e. dominance), whilst the later are trying to increase share. Big 4 firms stressed the adequacy of partner rotation as an alternative for tendering and highlighted its potential negative impact on audit quality (due to loss of institutional knowledge), and threats to auditor independence. The negative impact on audit quality was also flagged by a number of companies. Interestingly, the impact on audit quality and auditor's independence were cited by other groups in support of tendering; mainly highlighted by institutional investors. The paper also shed lights on the positions of other stakeholders such as professional bodies, consultancy firm, and lobbyist associations; none of which were against tendering.

The results reported in this study should be viewed with the limitations of content analysis in mind. Perhaps the biggest limitation is related to the coding process. The explanation of the views expressed in each letter is a subjective matter and frequently the views were not spelled out clearly. However, by involving two researchers in the coding process and holding discussions to deal with confusing comments, the potential effect of this limitation on the findings was minimized.

The debate on audit tendering is still going on with expected consultations in futures revisions to the UK Corporate Governance Code. The findings of this paper should inform interested parties in understanding

the views of the different stakeholder groups. The recent EU audit reform includes provisions for audit tendering. Both the UK's BIS and the FRC have published consultation documents regarding the alternative pathways to adopt the new EU directive. The analysis of the responses to both consultation and linking the results to this study is an opportunity for future research to enhance our understanding of audit tendering and its role in shaping the audit profession/market in the future. Other directions for future research include an investigation of the impact of audit tendering on the audit market structure and to study how audit committees assess the effectiveness of the auditor.

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Appendix

Table 1: Summary of Letters by Stakeholder Group

	Frequency		Avg.
	No.	%	Words
Auditing Firms	9	15	1177
Companies	15	25	330
Professional Bodies	6	10	135
Consultancy	4	7	497
Institutional Investors	10	16	267
Lobbyist Associations and Societies	11	18	312
Advisory	3	5	471
Private Capacity	3	5	366
Total / Overall Average	61	100	442

Table 2: FRC Proposals on Tendering

Proposal	Explanation
P1: Tendering	FTSE 350 companies should put the external audit contract out to tender at least once every ten years
P2: Comply or Explain	Comply with the UK Corporate Governance code provisions with regard to tendering or explain reasons for non-compliance
P3: Tendering Frequency	The most relevant time to call for the tendering process; ten years as suggested by the FRC
P4: Transitional Arrangements	The combined effect of these proposals would be to defer the date for tendering the audit contract of a significant number of FTSE 100 companies until 2018 or later
P5: Previous Year Disclosure	Companies to disclose their intention to make the audit contract out to tender in the previous year's annual reports

Table 3: Overall Findings

	Support		Against		No Comment		Total
Tendering	51	83.6%	9	14.8%	1	1.6%	61
Comply or Explain	39	63.9%	4	6.6%	18	29.5%	61
Tendering Frequency	22	36.1%	23	37.7%	16	26.2%	61
Transitional Arrangements	36	59.0%	3	4.9%	22	36.1%	61
Previous Year Disclosure	24	39.3%	7	11.5%	30	49.2%	61

Table 4: Findings by Stakeholder

Panel (A): Tendering							
Group	Support		Against		No Comment		Total
		<i>%</i>		<i>%</i>		<i>%</i>	
Auditing Firms	5	56	4	44	0	0	9
Companies	12	80	3	20	0	0	15
Professional Bodies	6	100	0	0	0	0	6
Consultancy	4	100	0	0	0	0	4
Institutional Investors	10	100	0	0	0	0	10
Lobbyists / Associations	10	91	0	0	1	9	11
Advisory	3	100	0	0	0	0	3
Private Capacity	1	33	2	67	0	0	3
				14.			
Total	51	83.6	9	8	1	1.6	61

Panel (B): Comply or Explain							
Auditing Firms	6	67	0	0	3	33	9
Companies	15	100	0	0	0	0	15
Professional Bodies	4	67	0	0	2	33	6
Consultancy	1	25	0	0	3	75	4
Institutional Investors	4	40	2	20	4	40	10
Lobbyists / Associations	7	64	1	9	3	27	11
Advisory	2	67	0	0	1	33	3
Private Capacity	0	0	1	33	2	67	3
					1	29.	
Total	39	63.9	4	6.6	8	5	61

Panel (C): Tendering Frequency							
Auditing Firms	3	33	3	33	3	33	9
Companies	7	47	6	40	2	13	15
Professional Bodies	4	67	0	0	2	33	6
Consultancy	0	0	2	50	2	50	4
Institutional Investors	3	30	5	50	2	20	10
Lobbyists / Associations	4	36	3	27	4	36	11
Advisory	1	33	1	33	1	33	3
Private Capacity	0	0	3	100	0	0	3
				37.		26.	
Total	22	36.1	23	7	6	2	61

Panel (D): Transitional Arrangements							
Auditing Firms	7	78	1	11	1	11	9
Companies	11	73	0	0	4	27	15
Professional Bodies	2	33	0	0	4	67	6
Consultancy	2	50	1	25	1	25	4
Institutional Investors	5	50	1	10	4	40	10
Lobbyists / Associations	7	64	0	0	4	36	11
Advisory	2	67	0	0	1	33	3
Private Capacity	0	0	0	0	3	100	3
					2	36.	
Total	36	59.0	3	4.9	2	1	61

Panel (E): Previous Year Disclosure							
Auditing Firms	4	44	1	11	4	44	9
Companies	9	60	2	13	4	27	15
Professional Bodies	2	33	0	0	4	67	6
Consultancy	1	25	0	0	3	75	4
Institutional Investors	5	50	0	0	5	50	10
Lobbyists / Associations	3	27	3	27	5	45	11
Advisory	0	0	0	0	3	100	3
Private Capacity	0	0	1	33	2	67	3
				11.	3	49.	
Total	24	39.3	7	5	0	2	61

Table 5: Big 4 versus non-Big 4 Audit Firms

Proposal	Support			Against			No Comment			Total
	Big-		non-	Big-		non-	Big-		non-	
	All	4	Big4	All	4	Big4	All	4	Big4	
Tendering	5	0	5	4	4	0	0	0	0	9
Comply or Explain	6	4	2	0	0	0	3	0	3	9
Tendering Frequency	3	0	3	3	3	0	3	1	2	9
Transitional Arrangements	7	2	5	1	1	0	1	1	0	9
Previous Year Disclosure	4	0	4	1	1	0	4	3	1	9