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Fee caps and the black list prompt firms to rethink audit strategy

by Richard Crump 15 May 2014

STRICT NEW RULES that limit the amount of consulting and tax advice companies can apportion to the firms that vet their books are forcing auditors to review how they tender for contracts, members of the profession have told *Accountancy Age*.

Under sweeping reforms passed by European politicians in April, large-listed companies are now required to tender their audit contracts once every ten years. The reforms build on similar moves taken by UK regulators, which imposed mandatory audit tendering among FTSE 350 companies last year, and already there has been a flurry lucrative contracts changing hands as a result.

However, it is the decision to cap the fees companies can pay their auditors and prohibit the provision of certain services that is having the most far-reaching effects on auditors' tendering strategies and client relationships.

"There is no one part of the market where this will be a critical issue, but the caps will require more careful management of non-audit relationships," says Mark Cardiff, head of audit at Grant Thornton. "Certain firms have traditionally charged a good degree for non-audit services."

The reforms, which are part of an attempt to instil greater competition among the audit profession, impose a 70% cap on the fees generated by firms for non-audit work, while certain non-audit services, such as tax advice and services linked to financial and investment strategy, have been banned altogether.

The black list of prohibited services, which proved one of the most contentious issues among member states when finalising the reforms, is designed to limit conflicts of interest in instances where auditors are involved in decisions impacting the way companies are managed and, coupled with the fee cap, could open up non-audit opportunities to other firms.

"The market opportunity for us may not be entirely in audit and may be for more in advisory services," explains James Roberts, audit partner at BDO. "It involves a different set of purchases made on a technical and value for money basis."

Project management

Indeed, more than a dozen FTSE 100 companies may have to reconsider the amount of non-audit work they give to their auditors in light of the fee cap, which is based on the average of fees paid in the last three consecutive financial years for the statutory audit.

According to research carried out by Manifest, the proxy voting agency, for *Accountancy Age*, 13 companies paid out more than 70% of audit fees for non-audit services over the last three years.

For instance, William Hill paid out 163% of its audit fee to auditors Deloitte for non-audit work, while Admiral and London Stock Exchange Group spent 114% each.

In 2013, London Stock Exchange group paid auditors PwC £2.9m in non-audit fees in 2012 and £0.9m in 2013, compared to £1.4m and £1.6m in audit fees over the same period. The majority of the non-audit fees related to corporate finance work in relation to mergers and acquisition advice provided by PwC, which has since been replaced as auditors by EY.

According to Cardiff, firms will be "very cautious" about taking on new pieces of work, particularly large one-off projects, such as M&A advice, corporate restructuring work and IT implementations "in case it gives rise to potential and unforeseen breaches in the future".

In one instance, a FTSE 350 company engaged its auditor to conduct a large piece of non-audit work. "Investors reviewed the issue and it triggered an audit tender as a result," Cardiff says.

Client power

This could mean firms will have to pass up some tasty pieces of work in order to protect their position as auditors, or likewise step back from tendering if big-ticket contracts are in the offing.

By far the most dominant form of non-audit work in terms of fees generated is tax advice and tax compliance work. According to the latest *Financial Director* audit fees survey, the FTSE 350 paid out £56m for tax advice and £50.7m for tax compliance work during 2012/13, compared to £44.9m for corporate finance work.

Under the EU's so-called black list, prohibited non-audit services include tax services relating to the preparation of tax forms, payroll tax, customs duties, identification of tax incentives unless required by law, support regarding tax inspections and provision of tax advice. Also banned is work related to the design and implantation of internal controls of risk management procedures associated with the preparation of financial information; valuation services and legal services.

However, Tony Cates, head of audit at KPMG, doesn't expect this to be a problem for the largest companies. "Further down the FTSE it will have more effect where people want more of a one-stop shop where auditors will do their tax work."

Nevertheless, the prohibition of tax work that is as lucrative for auditors as it is important for their clients, is leading firms and company audit committees to take a step back and reconsider whether the audit, or tax, work is most valuable to each party.

"Some of the big pitches we have been involved with we have wanted to pitch for the audit and not be given anything else," explains Cates. "But our view has been to say ‘you are the client and we will do what you want.' You can get very strategic on this, but in the end the client decides."

Unravelling work

Whether for tax work or other assurance services, firms are going to have to be forward-thinking if they are to un-pick complex arrangements in time to retain or win new audit contracts.

Indeed, the increased frequency with which audit contracts will come onto to the market means that firms will have to look closely at services they already provide to prospective audit clients. When audits rarely, if ever, came up for tender, conflicts of interest from big strategic projects were unlikely to arise.

A harbinger of things to come could be the recent case of Unilever, which under Anglo-Dutch listing rules was forced to replace PwC as its auditor. KPMG won the bid but, more importantly, EY did not pitch for the work because it was already a strategic supplier to the business.

In this instance, the tender process left little time for EY to address any independence issues associated with its pre-existing Unilever work, unlike a decision not to bid for the audit being driven by commercial pressures.

At least EY was able to discover the conflicts before pitching for the work. In the case of Schroders, KPMG was less fortunate when it successfully won the chance to vet the accounts of the FTSE 100 fund manager. Having been confirmed as the new auditor in January last year, PwC was quietly ushered back in two months later after KPMG revealed its appointment would conflict with other interests.

"You have to plan ahead as to what organisation to target for what service," says Cardiff.

Another example cited is that of a firm dropping its role as an internal auditor to win the external audit. Firms are managing such commercial decisions.

Grey area

It is in the area of non-audit work where the EU has veered away from the stance taken in the UK. And despite the publication of the black list, there is still a level of doubt about how best adhere to the list. At the very least, some of the wording is open to interpretation and comes with a level of ambiguity.

For instance, it prohibits "services that involve playing any part in the management or decision-making process of the audited entity". As has been seen in the case of financial reporting, the concept of materiality is open to interpretation. With regards to tax work, does 'material' refer to the audit committee, investors, of its impact on the financial statement or fees? Material will mean different things to each party.

However, firms are expected to err on the side of caution when interpreting the list. Any attempts to use ambiguity in the text for commercial gain would be a "mug's game", according to Roberts at BDO, while Cardiff says it is up for firms to decide how aggressive they want to be.

"We not only think it is appropriate to work to the letter of the law, but also the spirit of the law," Cardiff says. "We will not be looking at taking a commercial line on this. The most important thing is that a firm not only has integrity, but also the perception of integrity."

The EU legislation is still to be transposed by individual member states, including the UK. And, annoyingly for some, member states will be allowed to include more stringent fee caps and apply more prohibited services than those mandated by the EU.

"The disappointment of EU legislation is there are so many options depending on which country you are in," says Cates. "It does look a mess."