

Engaging Auditors: Field Investigation of a Courtship

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ABSTRACT: We report results of a field investigation of the process by which clients and their auditors enter an engagement. To examine this important element of the market for audit services, we obtain documents and conduct interviews on a requests for audit proposal (RFP) issued by a publicly traded Canadian company and a government organization. We observed: (1) low involvement of the audit committee in selection of the external auditor; (2) asymmetry of power whereby the client asks for information but the auditors are reluctant to do; (3) selection process that requires the auditor to provide quality-of-service references from senior officers of other clients, and show commitment to the client; and (4) extensive price competition where one audit firm offered a low-ball bid, and another firm offered three prices for different bundles of services. Implications of these observations are discussed.

Key words: Auditor-Client engagement, client selection, auditor rotation, independence

JEL Codes: M41, M44

Data Availability: Summary of Data is available from the authors

Preliminary Draft, July 30, 2009

- To do:
1. Add in interview scripts for auditor and for clients (Appendix B)
 2. Clarify audit committee interaction with auditor teams
 3. Add more content from other cases?
 4. Check all assertions and fix writing
 5. Make sure no mention of company name or industry (especially in appendix)

Engaging Auditors: Field Investigation of a Courtship

I. INTRODUCTION

Courtship appears to be an appropriate metaphor for the interaction between clients and auditors before they get engaged. This interaction is deliberate, individualized, dynamic, strategic, and occurs under significant uncertainty and consequences for both parties. Different disciplinary approaches to the same phenomenon choose different abstractions to get useful insights. The purpose of this investigation is to do the opposite of abstraction—delving into the rich, diverse, and complex interactions between auditors and clients—by documenting some raw observations which may serve as inputs to the more familiar traditional analyses from disciplinary perspectives. We supplement these observations with some preliminary discussion and conjectures of our own.

Detailed reports on direct observation and analysis of a single, instance of phenomena have a rich tradition in social sciences (e.g., Graham Allison 1971, on the Cuban missile crisis and Anthony Downs 1967 on workings of bureaucracies). Such direct observation is especially important in an institutionalized discipline such as accounting as articulated by Cooper and Morgan (2008) and exemplified in Cushing and Loebbecke (1986) on audit methodologies of large accounting firms, Hirst and Koonce (1996) on audit analytical procedures, and Hilton and O'Brien (2009) on asset impairment. In the methodological portfolio which includes gathering, codification, and analysis of data from large samples, there is room for case studies of small samples that permit the details (which must necessarily be suppressed in studies of larger samples) to bring the phenomenon to life and yield a different type of insights.

Our case study has potential to enrich our understanding of how clients engage auditors because we have access to confidential records obtained from companies (request for proposal for audit services – RFP’s) as well as audit firms (bid documents submitted in response to these RFP’s). The documentary record was supplemented by interviews with senior officers of the client and audit partners who prepared the bids, conducted by the researchers after they had reviewed the documents. Two other interesting features of the public company we study. A change in the engagement partner caused by auditor rotation rules, led to the audit being put up for bid and a change in (rotation of) the audit firm. This gives us a unique opportunity to assess the potential benefits (or lack thereof) from rotation of the audit firm (and audit partner). Second, our case study focuses on a profitable, growing, and highly successful firm targeted by all Big 4 firms as a desirable client. Studies of risk management, and especially of client acceptance, usually focus on less desirable clients (Johnstone and Bedard 2003).

The field investigation of the two cases reported here serves several ends. First, it allows those interested in examination of audit services to learn about the details of auditor-client engagement which might have remained unreported and unknown in the public record. These details offer them opportunity to decide if any of them are worth including in the models (as opposed to being ignored, which is the default option for what we do not know). Second, the details raise new questions and provoke thought and conjectures about the phenomena. Third, they rich provide materials for nuanced class discussion to assist the education and training of accountants.

The rest of the paper is organized as follows. Section II describes the method used to gather data. The main body of the paper consists of four sections on what we observed

about various aspects of auditor-client interaction leading up to engagement of an auditor, with some discussion and tentative conjectures of our own. Section III reports the role of the audit committee in this auditor selection process, Section IV describes the process of information acquisition by management and the auditor; Section V reports on how the auditor's try to convey their expertise; Section VI reports on how the auditor and client seek to establish mutual rapport and fit; and Section VII reports on the role of fees and how the auditor probes what services the client might be willing to pay for, and how much. Section VIII contains a summary and discussion of the paper as well as possibilities for future research.

II. METHOD

To develop an understanding of the auditor-client courtship, we followed a seven step process:

1. We obtained a request for proposal (RFP) document issued by a large (>\$10 Billion in assets) Canadian company (Client 1), which sought to change its external auditor for fiscal year 2008. The company is listed on the Toronto Stock Exchange (TSX) and is in an industry subject to federal regulation. The company's management team is widely admired and has a long track record of consistent growth in sales and profit, with a conservative balance sheet. The RFP was sent by the company to the Big 4 audit firms only and provides a written record of what the company wanted to know about its prospective auditors. The incumbent (one of the Big 4 firms) had audited the client for 25 years and was included in the RFP. Partner rotation in the incumbent firm, as well as knowledge that partners of other audit firms with significant industry experience become available to take on new clients (as they rotate off their existing clients), helped

precipitate putting this audit up for bid. The CFO and audit committee chair thought the local office of their incumbent Big-4 firm lacked depth of industry expertise to continue providing proper service in the future. The client was open to having an engagement partner and/or substantial part of the audit team expertise being brought in from another city. The RFP includes audit and reviews of the client and its subsidiaries but does not include tax or other advisory services. Audit firms were, however, invited to provide information on their tax and advisory services.

The RFP is included in Appendix A. As a cross-check on our observations in this case, we also gathered the RFPs issued for audits (as well as other documents described in this section) of one government-funded organization, and for five other organizations (of which one is a publicly traded company). Our observations about the case of Client 1 are supplemented with comments on these secondary cases as appropriate.

2. The RFP included a list of the documents the client made available (in a data room, subject to signing of a confidentiality agreement) to assist prospective auditors in developing a bid.
3. We obtained a copy of the bid document from all Big 4 audit firms who bid for this audit.
4. We interviewed the chief financial officer (CFO) and the chair of the audit committee of the company. Each interview took 60-90 minutes and followed a standard script based on information items requested in the RFP document. The interview script is included in Appendix B. The interviews were taped and hand written notes were taken during the interview. We also asked the CFO and the audit committee chair what additional information they had learnt about each audit firm through their oral discussions, what

additional questions they had asked the audit firms, and what questions the auditors asked them.

5. We interviewed each of the four proposed engagement audit partners, who oversaw the development of the bid document. Each interview took 60-90 minutes and followed a standard interview script (see Appendix B). The interviews were taped and hand written notes were taken during the interview. We asked the audit partners what additional information they learnt from the oral discussions, what additional questions they asked the company, and what questions company personnel had asked them.

6. Steps 1-5 were repeated for an audit put up for bid in a government-funded organization (Client 2) for which 3 of the Big-4 audit firms submitted a bid. The government-funded organization was large and prestigious and had a budget of more than \$ 2 Billion in 2008.

7. We obtained 5 additional recent RFP's from five other business organizations (1 was publicly traded, the other were not), together with the written bid submitted by one Big 4 audit firm on all 5 potential engagements (Organization 3-7). All interviews were taped and a transcript of the interview, together with the company and auditor documents (RFP, bids) constitute the primary data for this study. We shall focus most of our attention on the first case, and use the information gathered from the other six cases as a cross-check on variations observed in practice. **(Karim: There is some repetition here from above).**

A summary of the documents and information gathered is shown in Table 1.

Insert Table 1 About here

Approval from the research ethics board was obtained prior to conducting the study. The client CFO, audit committee chair, and local managing partners of all Big-4 audit firms were recruited to participate in the study. The managing partners identified the proposed lead engagement partner and authorized the release of their respective proposals (bids) and arranged interviews with the engagement partners. Participants were told that it was a study of what information and understanding was produced as part of the RFP process. Each participant (and firm) signed a consent form, was promised confidentiality, a copy of the written research report, and the opportunity to suggest corrections of any errors or misunderstandings on our part.

One of the authors prepared a table summarizing the transcripts of interviews and contents of bid documents. Two independent coders, both Canadian Chartered Accountants, independently read all materials and coded them into the same summary table. Coding differences were discussed and resolved by the two independent coders. The following four sections of the paper discuss the idea units coded in this table.¹

The RFP describes the task, the selection committee, time deadlines for responses and some constraints on page limits and topics to be addressed. Upon signing a confidentiality agreement, prospective auditors were invited to enter into an information acquisition process. The client made internal and external documents and senior managers available to discuss issues with the auditor. The RFP asked the auditor to demonstrate expertise, asked a series of questions about rapport and cultural fit, fees, transition and communication issues. We use the framework of the RFP to organize our observations (selection, information acquisition, expertise, cultural fit, fees) in this paper.

¹ Not included in the paper because of its length, this table is available from the authors on request.

III. AUDITOR SELECTION

Client 1 is a publicly traded company regulated by the Toronto Stock Exchange (TSX) and Ontario Securities Commission (OSC). The regulations require that the company have an audit committee (Rule 52-110). One of the key functions of the audit committee is to recommend the selection of the independent external auditor to the board of directors. We thus expected the audit committee to play a central role in the selection process.²

Minimal Involvement of the Audit Committee in Auditor Selection

Our examination of the auditor engagement process revealed surprisingly limited involvement of the audit committee of the board in selection of auditors. The RFP was sent out by the CFO and not by the audit committee. Our examination of the other six cases and interviews with audit partners suggests this is currently the norm in Canada. The selection committee had six company executives including the CEO and the CFO, all listed by name and position in the RFP. The chair of the board's audit committee was listed by name along with "Members of the audit committee" and neither the number (4) nor the names of the other individual members were given. An executive member of the selection committee—the chief accountant—was listed as the single point of contact for all inquiries related to the proposal process, site visits and interviews. The respondents to the RFP were explicitly prohibited from any direct contact with any officer or director of the client under threat of disqualification. Members of the audit committee (except the chair) were not included in the list of people available for the prospective auditors to meet, and the interview with the chair of the Audit Committee (as were all other interviews) was restricted to 30 minutes and three persons from the audit firm.

² "The audit committee must recommend to the board the appointment of external auditors who shall report directly to the committee." Ontario Securities Commission (2004).

The selection committee was to make its recommendation to the audit committee, who in turn was to make its recommendation to the Board and the shareholders. The chief accountant was the single point of contact and no information was provided on how to contact the chair or the members of the audit committee. Our interviews revealed no meeting between the prospective auditors and members of the audit committee (other than the chair) without the presence of company executives. The timeline in the RFP shows a six day interval in which auditors made their presentation to the selection committee, and approval of the selection by the board of directors; the time line includes no date for approval of the selection by the audit committee.

Given the applicable laws on selection of independent auditors (Ontario Securities Commission 2004), this level of involvement of the audit committee of the board appeared to be limited. All the auditors interviewed said that their level of engagement with the audit committee of Client 1 during the selection process was better than average and that audit committees are not usually the driver of this process. A review of RFP documents from a government organization and five other organizations also show the process being run by the CFO with no involvement by the audit committee in the government funded organization, and some involvement of the audit committee chair, but not of the other members of the audit committee for the other organizations (one is publicly traded). Previous studies in Canada (Gibbins et al., 2001) and the U.S. (Beasley et al., 2009) have also found that many audit committees play a limited and sometimes ceremonial role rather than a substantive and engaged monitoring role.

IV. INFORMATION ACQUISITION

Clients make extensive documents available to prospective auditors during the RFP process in a data room. These include public documents (such as annual and quarterly reports to shareholders) as well as confidential documents (such as business and strategic plans, Board and committee minutes, and investment listings).³ Going into the project, we had expected that the auditors would be highly interested in risk related information made available to them by the clients. We learnt from the interviews that this was not the case. Instead, their efforts were centered on personal meetings and conversations to understand the clients, to build a relationship, and to sell themselves.

Auditors did not pay much attention to internal control weaknesses of the client reported in the most recent management letter from the incumbent auditors, nor did they seem to be concerned with the accounting adjustments and reporting issues listed by the incumbent auditor, bargaining on these items and unadjusted errors. They also showed little interest in assessment of internal auditing system of the client. Auditors felt that they could not ask the client for certain items such as the schedule of unadjusted errors although they had the right (as well as need, in our opinion) to do so. Although management letters issued by the incumbent auditor for the last 2 years were available to them in the data room, two of the three non-incumbent auditors said that they had not read the management letters. Auditors did not ask to see correspondence with the federal regulator on accounting related issues, what internal reports were prepared for the board and audit committee, or breakdowns of how the incumbent auditor allocated staff time. One audit partner explained it as follows: “*Company X would be such a big frog in a*

³ See the list of documents provided by Client 1 its prospective auditors (upon signing of a confidentiality agreement) in its RFP in the Appendix.

small pond for any of the audit firms that I can understand why they probably all had the attitude of we don't care how ugly it is we want the brand and we want the business."

Managers, on the other hand, were quite assertive in obtaining answers they were interested in. For example, they wanted to know the auditors' reasoning and process for arriving at accounting estimates and judgments that were critical to them. They also wanted to make sure that there were no accounting policy differences between the company and the auditor, especially any that might lead to immediate restatements. To quote the audit committee chair: *"We were very concerned about making sure that they believed they knew enough of the company's results, and the company's transactions, to ensure that they did not view the risk of restatement as being even a low probability that was, we wanted to clear that outright from the start."*

Managers were also interested in any lawsuits against the auditor and whether they would distract the auditor and /or create a reputation risk for the company. Management showed no interest in results of Canadian Public Accountability Board (CPAB) reports. CPAB reports are issued privately to audit firms in Canada (as opposed to PCAOB reports which are public in the U.S.).

We conjecture that the difference in the information acquisition by client and auditors may be attributable to the auditors' lack of bargaining power vis-à-vis management. Probing a client too deeply on sensitive issues during courtship may generate enough antagonism to rule out the hoped-for engagement. Some aspects of auditors' apparent lack of interest in what we had thought was critical information might be attributable to their prior due diligence and the desirability of this client (but they could not have known the unadjusted errors through their own independent

investigations). Perhaps the auditors focused on trying to better assess senior management's candor, forthrightness, competence and integrity.

In Client 2 (the government organization) more information (total hours budget, and budget for each account/major location, control weaknesses, issues raising audit concerns) from the incumbent auditor was made available in the data room. To ensure an even playing field, one common question and answer session was organized where all auditors were asked to submit questions ahead of time, and one set of responses were provided. The auditors were reluctant to ask questions in this common forum and relied more on examination of documents provided by management, and less on the personal contact we observed to be dominant in the case of Client 1.

Feedback from Client to Auditors on the RFP Process

The RFPs listed post-selection debriefing from client to the bidders as a part of the process with a calendar date assigned to the task. From our interviews with the auditors, it was clear that this debriefing was extensive. The auditors were well-informed about their competitors' proposals and the client's assessment of each competitor. We observed a similar detailed and informative feedback process in the government organization as well. We are uncertain about the reasons for providing such detailed debriefing by the client, and its consequences. It is not common in most areas of the economy where competitors bid for jobs, for all bidders to be given such extensive feedback about their own and other competitor's bids. Perhaps it could be linked to the client's desire to gain advantage by promoting intense competition among auditors. This level of debriefing also suggests that it is difficult for an audit firm to develop any proprietary strategies or response formats. Bids from audit firms appear very similar

(making it harder for audit firms to differentiate themselves) partly because of structure imposed by the client, but also due to common knowledge aspect of client feedback about what features were effective (ineffective) in the bid process.⁴

V. EXPERTISE

Each audit firm assembled an audit team with multiple relationship partners, engagement partners, managers, seniors and junior auditors. All senior personnel both in the local office and head or supporting regional office had industry specific experience which was spelled out in detail. Key quality control partner(s) in head office, tax partners, and the lead IT partner were also introduced to the client. These staff introductions took 5-12 pages in the bids submitted by the audit firms, and the 30-page limit stated in the RFP was exceeded by all. One audit firm proposed to move a partner with industry experience to the head office city of the client, and a second audit firm proposed to move a senior manager with industry experience to the head office city of the client. In addition, extensive descriptions were provided on the audit firm's market share in the industry regionally or globally. Several industry specific clients were introduced and the number of professional staff with industry specific experience was highlighted. All bids listed an extensive set of professional resources provided by each audit firm including forums, websites, roundtables, e-mail alerts and a variety of industry specific publications.

Membership of audit firm personnel on advisory committees in the relevant industry associations, or regulatory advisory bodies was especially valued by the client.

⁴ We can argue that this process has moved audit service toward being a commodity. The chief accountant of Client 1 said the audit proposals were 90 percent the same. In spite of being judged competent to do the job, all auditors were able to differentiate themselves in the eyes of the client with respect to technical depth, responsiveness to the client, centralization, and the personal relationship of specific audit personnel with the client management.

These activities were seen as keeping the auditor at the leading edge of recent developments as well as providing a platform for management and its issues to be given due consideration by regulators. Further, the proposed audit partner's familiarity not only with the management of the client but also of competitors was considered desirable. Perhaps the concerns about conflict of interest and leakage of proprietary information are dominated by the advantages of a counter-flow of informal information and the auditor's potential as a connecting link to the larger industry and the regulators. The client saw the auditor as a potential source of leads to new business customers as well as competitors it wanted to collaborate with. Engagement partner's knowledge of and relationships with senior managers of a major regional competitor was especially valued. The RFP explicitly asked auditors to provide a "*Summary of relevant training and/or networking opportunities (with locations) offered to your clients.*"

While it was possible conceptually to attempt a ranking of audit firms in terms of industry specific expertise, it was clear to all participants that all four bidders had good technical expertise and could do a good audit of this client. The formidable amount of technical skill and resources may help set apart Big 4 firms from smaller audit firms. However, the big 4 firms did not have very much differential expertise among themselves. Quoting the CFO: "*We all unanimously felt that every firm could do the job very well with the team they had presented.*" One of the audit partners also expressed frustration that in a highly standardized accounting environment it was hard for the audit firm to differentiate itself from its competitors (audit quality is unobservable), and thus often the firm with the lowest price would win the job.

Despite the extensive technical expertise possessed by each bidder, this expertise became largely neutralized as a differentiation factor in selecting an auditor for this client. We observed a similar team building process in the government organization, with very little expertise-based differentiation among the audit firms bidding for the engagement.

Interview with the CFO of Client 1 pointed to another possibility. Perhaps the client had in mind the industry experience and expertise of a particular person who had become available to become the engagement partner after being rotated off another company in the same industry. Although the CFO said that the incumbent firm had 50 percent chance of getting the assignment, the incumbent thought that it had little chance of getting it. Incumbent was the only firm that did not bring its CEO to meet the selection committee. The management and the audit committee chair sensed that such low expectations may have led the incumbent to behave in a way that lowered its chance of getting the job which, at the outset, “was theirs to lose.”

VI. RAPPORT AND CULTURAL FIT

“There are processes and there are structures, but people do business with people.”

---Managing Partner, Big 4 accounting firm

The neutralization of expertise as a differentiating variable made rapport and cultural fit a more important part of the auditor selection process. The interviews revealed that the issuance of the RFP by Client 1 was not the beginning of the courtship. All four invited auditors knew that the RFP was coming well before it was issued. All audit firms had active business development processes through which they had already targeted this enterprise as a client they would like to serve as its auditor. The auditors had been

visiting the senior managers (CFO/CEO) of the client in their offices, or inviting them to dinner and presentations in order to express their interest, exchange information, and develop personal *rapport* well before the issuance of the RFP. Interviews with the client and incumbent auditor indicated that the client had been dissatisfied with the engagement partner who had taken over in the preceding year as a result of internal rotation in the audit firm (didn't like his "*bedside manner*" they said). This pre-courting behavior also suggests that the senior managers (CEO, CFO), and not the audit committee, were the key players in this process. To show their commitment to obtaining and valuing this client, two non-incumbent auditor teams were headed by their respective national CEO's and one by the national vice-CEO. These CEO's (vice CEO) were also designated in the proposals (bids) as the lead relationship partners for this client.

Mirroring the Client

Imitating the style, dress, appearance, and manners of those one wishes to please is as old as human history. One should not be surprised to find the auditors, too, employ such tactics in courting prospective clients. Their written proposals reveal that they tended to mirror the clients in many ways. The roles of the references provided tend to match those of the client personnel on the selection committee; since the RFP was issued by the CFO, so were most references (out of 18 references provided, 14 were CFOs, 2 CEOs, 1 vice president of information technology, and only one chair of the audit committee). The reliance of the audit partner on references from current clients to get future clients is potentially troubling for auditor independence. It was clear that to both the CFO and the audit committee chair, auditor reputation meant the engagement partners' personal reputation with other CFO's which was classified as either rigid (undesirable) or flexible (desirable); or sometimes as issuing edicts (undesirable) versus

discussing a rationale for accounting treatment (desirable). We saw no evidence of reputation with investors or any third party users of financial statements being a consideration. The audit committee chair said: *“The most important issue for us is their reputation that we can discern by references on how they operate with other companies in our industry.”*

Auditors adopted client slogans in the auditor proposals and presentations as they strove to show a better fit between their organizations with respect to culture, thinking, and attitudes. What does it take to be a good independent auditor of a given client? Absence of a prior relationship is one thing that comes to mind. However, in our investigation we observed a strong relationship orientation in the auditors and that having a prior relationship with the prospective client was the first qualification to be on the audit team. Location and industry specific expertise also help an individual get on the team. This relationship preference is not limited to the engagement partner but percolates down all the way to the junior auditors.

Partner Autonomy versus Quality Control by the Head Office

One complication occurred in the bid process because the client made it clear that they preferred to have senior audit firm expertise available locally, and wanted all complex (euphemism for contentious?) accounting issues to be resolved locally. Entrepreneurial firms tend to be impatient with rules imposed by distant bureaucracies and would rather trust a person they know, and want to understand the thought process of the audit partner who has final decision making authority. In the aftermath of the collapse of Enron and Arthur Andersen, LLP, this insistence on local partner autonomy is a sensitive issue for Big-4 audit firms.

One of the reasons often given for the collapse of Arthur Andersen was the transfer of authority for making the final call on disputed technical issues from its vaunted headquarters unit of experts in Chicago to the local engagement partners (Toffler 2003). Apparently, the headquarters unit served several important functions including (1) have a high level of expertise available to all audit engagements irrespective of their location; (2) enforce a uniform application of judgment across the firm; and (3) protect the engagement partners from undue pressure from client executives by allowing them a shelter behind the opinion of the headquarters experts when differences with client executives arose.

In the interviews it was clear that all four audit firms understood that the client wanted local partner autonomy and all complex accounting decisions to be made by the engagement partner.⁵ Two audit firms sought to address this issue in their bids by providing a description of their process to identify, discuss, and communicate such issues without promising local control. Two others responded by promising that the final and binding decision on complex (contentious?) accounting matters will be made by the engagement partner. One firm promised that they “*do not hide behind the head office.*” Out of the two audit firms who promised this level of partner autonomy in their written bid, one firm indicated that they saw this as a communication issue and not a substantive issue. The engagement partner would be subject to the audit firm’s normal consultation and quality control processes, and they were just promising that the engagement partner would be a single point of contact for all accounting related discussions with the client. Not being able to use quality control as a bargaining tactic (e.g., I sympathize with your

⁵ Since local partners claim a larger part of the engagement revenue than their share of the cost of damage to the reputation of the international firm, protecting this reputation from local negligence presents a difficult agency problem for the audit firm. It also is a reason for the clients to want local control.

position, but quality control says No) in future sessions with the client was not thought to be an important concession. The second firm indicated that the audit partner did in fact have autonomy and could decide if and when (s)he needed to consult head office. As a practical matter, client cannot know whether the local partner or the head office makes the decision; they can only identify the person who conveys the final NO to them on a contentious item. In this sense, it is indeed only a communication decision.

Research studies indicate that having a technical head office partner involved in the negotiation is beneficial to the audit firm (Gibbins et al., 2001). Likewise, team negotiation has been found to be more effective than individual negotiation in many accountability related contexts (O'Connor 1997). Audit firms appear to be split on the benefits of involving head office technical experts in their client communication and negotiation processes.

In the government organization we observed much less activity towards building rapport and cultural fit. There was no pre-courting, no use of client slogans, much less oral and personal one-to-one communication, and much less mirroring and marketing feel to the proposals. However, prior relationship with the client was still a key determinant for choosing audit team members.

VIII. AUDIT FEES

The Client 1 RFP calls for bids for the first two years of audit engagement. The two year bid places an additional constraint on the ability of auditors to low-ball the fees in order to get the job. Bids for total engagement fee varied from 74 percent to 125 percent of the current fee, with the low bidder getting the engagement. That the incumbent auditor would bid 100 percent of the current fee was common knowledge

expectation among the other auditors (and was accurate). Although the RFP voiced a preference for greater involvement of senior auditors in the work, the low bidder (who was awarded the job) proposed to do so by increasing staff hours substantially and decreasing partner/managers hours substantially relative to the incumbent's current year time budget. In the interviews, both the audit committee chair and the CFO expressed some concern that a low bid meant the auditor might not have understood the amount of work involved. The CFO said: *"For Audit Firm X, we were not sure on how they would do because the audit fee was too low.... I think they may have underestimated the work they needed to do on a couple of our subsidiaries."*

The bid of another auditor⁶ was 96 percent of the current year fee, and the bid of a fourth auditor was 107 percent of the current fee for substantially more partner/manager hours and more than double the number of staff hours relative to the incumbent auditors time budget. The chairman of the audit committee did not consider the hours given by this fourth auditor as credible and thought they were deliberately trying to frame a low hourly rate.⁷ All the audit firms had developed a table breaking down fees by rank and financial statement account (sales, receivables) but the client appeared not to have paid much attention to these numbers in making the engagement decision. Our conjecture is that the tables that breakdown the total quoted fee into hourly rates, hours, and task components help clients reduce auditor's degrees of freedom and serve as additional bargaining and monitoring instruments (allowing cross-checking the auditor billings against the accepted bids).

⁶ This fourth auditor submitted three different hours-price bids, more on which later.

⁷ "Because clients do not monitor the number of hours their auditors spend on the assignment, the hourly billing rate is not a meaningful measure of price. The total price of the audit assignment—the price of buying the audit certificate—is the relevant price variable." Sunder (1997, pp. 117-8).

Interestingly, one (non-incumbent) auditor submitted bids for three different levels of audit service. In addition to the bid for 107 percent of the current fee, the other two bids were priced at 89 percent and 125 percent respectively. The premium priced service promised more experienced partner and staff on the engagement, more frequent meetings to explore any issues, more “free” time to consult on issues, more customer satisfaction discussions, more strategy and business advisory sessions with senior industry leaders, more client involvement in audit planning and more integration with the company’s internal audit. The discounted fee option required extensive work commitment from the internal audit department of the company and less frequent meetings and advisory discussions.

This endogenous and spontaneous appearance of multiple bids for service of variable quality in a regulated domain raises several intriguing questions. How do we rank these three levels of service? What should be the regulatory stand on such variety of service levels? What does this multi-level bid imply for the current regulatory regime? What does the gradation of partners imply for the value of the audit firm and its brand? What parallels does this practice have in other learned professions? We cannot address any of these questions definitively. Yet, the unexpected appearance of this practice does provoke some rethinking about some long-held beliefs about the pricing of audit services.

How the three levels of service are evaluated by the client depends on who we regard as the auditor’s client. If shareholders, especially the small ones, are the clients, more experienced partner (assuming (s)he is honest), and more frequent meetings to explore and resolve issues are pluses, more customer (management?) satisfaction and client involvement in audit planning are minuses, and better integration with the

company's internal audit and advisory services has ambiguous consequences. Thus one cannot be sure if the benefits from the premium audit service will be large enough to justify the higher fees. From the point of view of management as a client, most features of the premium service seem desirable.

The current regulatory regime mandates publicly-held companies to be audited by independent auditors in order to protect the interests of investors and others. Since quality of audits is difficult to observe and to specify, the regulatory regime establishes a series of procedural specifications and checks on audits. If the auditor offers multiple levels of service, the minimal level should satisfy the regulatory requirements. The add-ons may represent additional services bundled with auditing to bypass any restrictions on their sale to audit clients. Alternatively, the premium services could be sold (and bought) as signaling devices by firms under more competent or confident managers to convey information to their shareholders in a way that the companies in less competent hands or with less promising prospects cannot afford to imitate. The former explanation rings a regulatory alarm bell, while the latter is a welcome supplement to better governance. The latter explanation also raises the question of whether such audit market signaling could replace the regulatory mandate for audits of publicly held companies (Jamal and Sunder 2009).

Though informal identification of audit managers and staff by seniority and industry experience has been common (e.g., senior manager), this is the first time we have seen this type of differentiation done by experience at the partner level. We were also surprised by the explicit pricing of different levels of experience (within rank differences) in an engagement bid. In professional service markets where services are

sold to retail customers (e.g., lasik eye surgery) it is common to see differential pricing based on the number of operations done by an eye surgeon. Whether audit firms will do better by such partner-level differentiation (as opposed to relying on the firm's brand name and a single billing rate for all partners) is an interesting and open question. In this case, the multiple billing options created confusion and the attempt to price experience of team members very explicitly backfired and undermined the credibility of the audit firm..

In the government organization, fees were also a sensitive issue and audit firms believed that it would be a major determinant of who won the engagement. Again the incumbent bid 100 percent of last years fee, and the rest bid just below that. There were no unusual (or multiple) fee levels proposed.

VII. DISCUSSION AND CONCLUSION

The company studied in this case was a successful and highly desired client. Yet it was troubling to see limited involvement of the audit committee, and the inability of the prospective auditors to access crucial information for properly assessing risk (e.g., schedule of unadjusted errors). These results suggest that new auditors are not only more vulnerable to fraud (Treadway 1978), but also to errors in early years. Difficulties encountered with new audit clients are partly due to the learning curve involved, but also due to lack of proper risk assessment during the client engagement process. Placing high reliance on management reputation and oral representations is a risky strategy for audit firms. For a Big-4 audit firm, systemic risk to the firm comes from its largest and potentially most desirable clients.

Each audit firm assembled a vast pool of talent (expertise) but found it difficult to differentiate on this dimension. One problem for the auditors was the client perception

that all four audit firms had the capacity to do a good job on this engagement. Audit firms thus had to differentiate themselves through their pre-courting behavior, bringing the national CEO to lead their presentation, being responsive to client desires for local expertise (e.g., offering to move an industry specialist partner to the head office city), mirroring the client by providing references of CFO's who are their current clients, and promising engagement partner autonomy. The CFO of Client 1 judged one audit firm dominating in expertise (marginally), a second in understanding of the client, and a third to have the best mix of skills locally and the engagement partner's good fit with the client in terms of relationships and reasoning process on accounting issues. It did not hurt that this auditor also submitted the lowest bid and won. The fourth auditor, the incumbent, was on the way out, and its bid was seen as little more than a formality. Inability of audit firms to create a clear expertise-based differentiation may be the most important factor undermining the profitability and independence of audit firms.

Auditor rotation has often been proposed as a way of preserving the independence of auditors from their clients. Rotation of auditors, either another engagement partner from the same firm, or better still, a different firm will bring a fresh set of eyes (Tan 1995), fewer blinders, and uproot entrenched relationships that may override their objectivity and independence. There are also well-known arguments against rotation as time and repetition can help the auditor develop perspective and expertise (Arel et. al, 2005).

This field investigation points us to another counter-argument. The very process of engaging a new auditor, combined with competition in the market for audit services, encourages auditor actions that weaken their independence. Auditor rotation merely

ensures that this weakening of independence is repeated every few years. Rotation affords clients the opportunity to shop for opinion, and avoid auditors who they don't like without having to fire them and raise regulatory red flags. Rotation also puts pressure on auditors to demonstrate responsiveness to the proposed management (and other clients being used as referrals) to win the engagement.

A rotation mandate requires an audit firm to have several industry specific experts in at least the major local offices to properly carry out an audit of large companies. The case indicates that even the Big-4 audit firms have difficulty maintaining such depth in local offices. This means that a partner rotation requirement will have the unintended effect of driving small and medium sized audit firms out of the market, and increasing the concentration of the audit market. It is difficult to see the countervailing benefits of rotation in our field observations in this case. The only benefit to shareholders from the process documented here was a lower audit fee. Further investigation of the matter may shed better light on the economic consequences of auditor rotation by regulatory mandate.

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Table 1: Documents and Information Gathered

| | Client 1 | Client 2 (Government) | Client 3-7 | Total |
|---|-----------------------------|----------------------------------|-----------------------|--------------|
| Request for Proposal (RFP) | YES | YES | YES | 7 |
| Data Room list of Data | YES | YES | NO | 2 |
| Bid – Audit Firm 1 | YES | YES | YES | 7 |
| Bid – other Audit Firms | YES – 3 other | YES – 2 other | NO | 5 |
| Interview with CFO | YES | YES | NO | 2 |
| Interview with Chair, Audit Committee | YES | NO | NO | 1 |
| Interview with Engagement Audit Partners | Yes- interviewed 4 partners | Yes- interviewed 3 partners | NO | 7 |
| Interview with other Government Audit officers | NO | YES- 2 others | NO | 2 |

Appendix A

**CLIENT
REQUEST FOR PROPOSAL
AUDIT SERVICES**

DATE

INTRODUCTION

X Company is approaching its 25th anniversary and has firmly established itself...At close to \$XX billion in balance sheet assets and more than Y years of double digit asset growth including XX percent over the last 12 months, the necessity to continually review business strategies and risks is paramount in ensuring sustained success.

Of late, there have been multiple and significant changes in accounting standards, regulations and the XYZ industry that have all combined to add a great deal of complexity to our business with no slowdown in sight. To name a few, the recent adoption of XYZ accounting standards, the upcoming implementation of the XYZ Industry regulations and the transition to IFRS over the next 5 years represent major changes to our business organization.

Against this backdrop, X company has determined it is timely to review the availability of financial services audit expertise and resources in Canada and is undertaking a Request for Proposal (RFP) for independent audit services. This document outlines the general principles of the RFP. We highlight that our preference would include the most senior expertise to be based in Region of Canada, but it is not essential.

All information will be provided to you in strict confidence. Please complete the RFP Acceptance and Confidentiality Agreement (Appendix A) and return it to Mr G as outlined in the Communications Section. The supplemental information package will not be distributed prior to the receipt of the RFP Acceptance and Confidentiality Agreement. Please note this RFP is being extended to Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.

SCOPE OF SERVICES

Your audit should be conducted in accordance with Canadian Generally Accepted Auditing Standards and will commence with the period ending year end date. The audit will be for the consolidated financial statements of X company.

The mandate will include a review of the interim financial statements for each of the interim periods. For greater clarity, the first interim review would be for the three months ending Date.

The mandate also includes:

- The statutory audit of Subsidiary 1, 2, and 3;
- Communication of weaknesses found in internal controls during the course of the financial statement audit;
- Analysis of accounting questions and issues in the context of the audit;
- Review of Management's Discussion and Analysis, Annual Information Form, and Annual Report to the extent required by professional standards;
- Review of quarterly report to shareholders (including financial statements and notes);
- Specified audit procedures for Subsidiary 4 as required by the New York Stock Exchange;

- Specified audit procedures and audit report on specified financial information for X Company as required by Industry Association;
- Review of audit working papers of Subsidiary 5's external auditors (Audit firm);
- Audit of financial statements of Special entity (non-consolidated special purpose entity with December 31 year-end).

Note: The RFP does not include the audit of Subsidiary 6.

RFP PROCESS DESCRIPTION

The RFP process will be conducted in the following phases:

- Information gathering;
- Submission of a written offer of services;
- Presentations; and
- Selection.

The Audit Committee has established a Selection Committee to oversee the RFP process. The Selection Committee is comprised of:

- A, Chair of the Audit Committee,
- Members of the Audit Committee,
- B, Chief Executive Officer,
- C, Chief Financial Officer,
- D, Chief Internal Auditor,
- E, Senior Vice President,
- F, General Counsel, and
- G, Chief Accountant.

The Selection Committee will make recommendations to the Audit Committee and the Audit Committee will select the external auditor for recommendation to the Board and shareholders.

COMMUNICATIONS

The RFP process will be open and equitable for all firms. We will endeavor to ensure all firms have access to the same information. No information in one proposal will be disclosed to another firm in the RFP process.

Management will be available to answer questions throughout the process. To aid in the information-gathering phase, a schedule of availability with management will be established.

To help ensure an efficient and equitable proposal process, Company X is requesting that each proposing firm comply with the following general guidelines:

- All inquiries relating to this proposal process, including arrangements for site visits and interviews, are to be directed to G, Chief Accountant. He will be your single point of contact. Contacting any other member, office or director of X Company could lead to disqualification. G's contact information follows:

Contact information

- To facilitate the review of the Company's information, a data room will be established at X Company's corporate office located at address. A list of information that will be available in the data room is attached as Appendix C.

- In addition, the following individuals will be available to meet with and provide each firm with their perspective of the critical business issues facing Company X. The individual interviews will be restricted to 30 minutes, unless an alternative time frame has been agreed upon in advance, and no more than three people from your firm should attend each interview. The Chief Accountant will coordinate the interviews.
 - B, Chief Executive Officer,
 - A, Chair of the Audit Committee,
 - C, Chief Financial Officer,
 - G, Chief Accountant,
 - F, General Counsel,
 - H, Treasurer,
 - D, Chief Internal Auditor,
 - I, Senior Vice President, Credit Risk Management,
 - J, Chief Technology Officer.

PROPOSAL FORM AND CONTENT

Eight (8) copies of the submissions are to be received by the undersigned no later than date. Your submissions should be no longer than 30 pages, plus curriculum vitae for proposed team members. The submission should contain the following:

1. Detailed description of audit approach
 - Approach
 - Methodology for assessment of risks and establishing audit approach
 - Risks identified
 - Scope and approach of work (including adoption of new significant accounting policies)
 - Objectives
 - Split of work among various locations and corporate functions
 - Communication with audit committee, including all communications required by X Company's Audit Committee Terms of Reference
 - Engagement Letter
 - Breakdown of audit hours for X Company audit broken down by major financial section for field staff (i.e. cash, ..., other assets) with partner and manager time noted in total.
 - Use of Internal Audit
 - Quality control
 - Independence policy
2. Expertise
 - Experience and location of the audit team members
 - Partners
 - Senior Managers / Managers
 - Industry expertise by location

- Brief summary of Industry 2 audit and assurance experience
 - Availability and location of resources for complex accounting questions
 - Functioning and size of professional practice groups
 - Availability of local resources
 - Confirmation that the firm is duly registered with the Canadian Public Accountability Board (CPAB)
3. Transition plan (if applicable)
- Description of transition plan to ensure minimum disruption to X Company management
 - Description of team experience in transition of audits, references if applicable
4. Independence
- Confirmation of your independence from X. Company.
 - If confirmation not available, then an explanation of the process to ensure independence.
5. Fees (including any separate fee for CPAB)
- An itemized fee quotation for the year ended Year 1.
 - An itemized fee estimate for the year ended Year 2
 - An itemized fee estimate for each entity and requirement listed.
6. References
- The Firm shall provide a list of clients (minimum three (3); maximum five (5)) that are significant Companies in Industry X who are currently major accounts of the Firm for services similar or identical to the Services outlined in this RFP. The firm will describe how the services provided to these references are similar to the services proposed to X Company.
- The Firm must include the client's company name, address, contact name, telephone number and e-mail address, and the length of the association. The Firm's references will be contacted.
7. Tax
- We would like you to address your view on the nature and extent of work that you could provide for tax compliance or tax planning activities.
8. Other services offered by your firm
- We would like your proposal to include an overview of the other services offered by your firm, remaining independent. Overview could include:
- Listing of relevant publications available

- Summary of relevant training and/or networking opportunities (with locations) offered to your clients

9. Presentation

The objective of the presentation is to allow you to present your offer for services, respond to the questions from the Selection Committee and allow us to meet your engagement team. Presentations to the Selection Committee are expected to be scheduled for Date with the Board decision to follow on Date.

We request that your oral presentation not exceed 60 minutes. After your presentation, thirty minutes will be allotted for questions and discussion.

EXPECTATIONS

Throughout the auditor/client relationship we expect:

- An open and professional rapport with direct access to decision makers for all accounting/auditing matters
- An efficient and effective risk-based audit process
- Significant and relevant industry experience of the members of the audit team
- As partners or managers assigned to the engagement change over time, the firm will agree to provide resumes of new personnel to ensure that each have the requisite technical knowledge and industry expertise to conduct a thorough and efficient audit
- All billings will be cleared in advance of submission. All billings should provide a detailed description of the work performed and a summary of the hours and rates billed by person.
- The annual audit plan will be reviewed with X Company and its Audit Committee in sufficient detail to allow X Company to understand your audit approach (including the assessment of significant risks) and efficiently prepare for the audit process.

TIMELINE

| Item | Date |
|---|-----------------------------|
| 1. RFP request letters sent to firms. | Date 1 |
| 2. Return of RFP Acceptance and Confidentiality Agreement | Date 1 + one Week = Date 2 |
| 3. Distribution of Supplemental Information package | Date 2 |
| 4. Data room availability | Date 2 + One Month = Date 3 |
| 5. Interviews | Date 3 + 1 day = Date 4 |
| 6. Receipt of submissions | Date 4 + 2 weeks = Date 5. |

- | | |
|--|--|
| 7. Presentation to Selection Committee | Date 5 + One Month = Date 6 |
| 8. Board approves selection | Date 6 + 6 days = Date 7 |
| 9. Communication of decision | Date 7 + 1 day = Date 8 |
| 10. Debrief for firms | Week commencing Date 8 + 9 days = Date 9 |

APPENDIX A

RFP Acceptance and Confidentiality Agreement

To: C, Chief Financial Officer

Fax: X Company

We accept the request to present a proposal to provide external audit services to the X Company . We agree to keep in confidence all information received by us in connection with the proposal process, including the Supplemental Information, not to disclose it to third parties, not to use it for any other purpose than for the proposal, and to destroy all paper and electronic information in the event that our firm is not selected to be the independent auditor as a result of this proposal process.

Firm Name: _____

Partner: _____

Contact Information: _____

e-mail: _____

APPENDIX B

Supplemental Information

(To be provided on receipt of signed RFP Acceptance and Confidentiality Agreement)

1. Organization structure
2. 2006 Annual Report, Annual Information Return and Management Information Circular.
3. Q3 2007 Report to Shareholders
4. Data room details and arrangements
5. List of statutory audits and most recent financial statements

APPENDIX C

Information to Be Available in the Data Room

1. Organizational Charts
 - Corporate structure
 - Executives
 - Finance
 - Internal Audit
 - Corporate Office
2. 2008 Strategic Plan; 2007 Business Plan
3. Consolidation worksheet (and entries) as at July 31, 2007
4. Asset Liability Committee Policy Manual
5. Board and Committee Minute Books
6. Accounting Policy Manual
7. Certification Project flowcharts for key controls
8. Quarterly financial reporting disclosure framework – Finance
9. Timeline for Interim and Annual Audit
10. Internal Audit Scope and Plan
11. Overview of IT Systems
12. Credit Risk Management loan portfolio distribution reports
13. Investment listings
14. Year-end working paper files – X Company, Subsidiary 1 and 2
15. Additional information

Appendix B: Interview Scripts for Auditors and Clients

1.