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# Auditor changes and tendering

## UK interview evidence

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"I am appointed by the Queen and that gives me a great deal of comfort" (Sir John Bourn, Comptroller and Auditor General)

### Introduction

Significant changes in the auditing environment world-wide have, in recent years, led to important changes in the behaviour of market participants. The main environmental changes have been the world-wide recession, dating from approximately 1989, which led to overcapacity on the supply side of the market. These changing competitive pressures resulted in aggressive fee renegotiation and competitive tendering of audit services by companies (see, for example, Beattie and Fearnley (1994) for the UK; and Lawson (1993) for Australia). Moizer (1994) specifically identifies tendering as a means by which independence is threatened: "the use of the tender process will enable the management to claim that the auditor was replaced because a cheaper one was found and not for any reasons of dispute between the company and the audit firm" (p. 20). There have been reports of, and evidence concerning, significant audit fee discounting (see, for example, *Accountancy* (1992) and *Accountancy Age* (26 May 1994) for the UK; Hancock (1993a) for South Africa; IAB (1993a) for Italy; and IAB (1993b) for Denmark; Johnson (1994) for Australia; and Maher *et al.* (1992) for the USA), lowballing (see, for example, Hancock (1993b) for Italy; LaFrentere and Carr (1991a) for Australia; LaFrentere and Carr (1991b) for Canada; and Pong and Whittington (1994) and *Financial Times* (18 May 1995) for the UK), and suggestions of cross-subsidization of audit costs from non-audit services (NAS) provided by audit firms (Peel and Brinn, 1993). In combination, these behavioral responses have produced an increase in the incidence of tendering and in the overall rate of auditor change. For example, Beattie and Fearnley (1994) estimate that the incidence of tendering by UK listed companies which had/had not changed auditor during the period 1987 to

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1991 to be 55 per cent and 6 per cent respectively, with 82 per cent of all tenders resulting in a change of auditor.

The importance of these economically-driven behavioural changes stems from their potential impact on auditor independence and audit quality, which regulatory bodies have sought to address (for example, AARF (1992) in Australia; AICPA (1992) in the US; FRC (1991), Cadbury Committee (1992), CAJEC (1992; 1993; and 1995), APB (1994), and ICAEW (1994 and 1995) in the UK; and MIA (1993) in Malaysia). Given the growing importance and frequency of tenders in the audit environment world-wide and the related concerns being expressed, the overall aims of this paper are to explore the nature of the tender process to understand more fully the reasons for auditor change and the basis of selection of the new auditor. Auditor choice theory suggests that, given the nature of the demand for external audit, auditor choice will be jointly influenced by auditee characteristics (particularly those related to agency costs), auditor characteristics (such as size, reputation, class and industry specialization) and the auditing environment (Wallace, 1980)[1]. Client-auditor realignments have been found to be generally attributable to temporal changes in client characteristics (Johnson and Lys, 1990)[2]. (For a comprehensive review of the theory and evidence linking auditor choice, audit fees and auditor concentration see Yardley *et al.* (1992).)

To our knowledge, the tender process has not previously been studied. The need for the consideration of matters such as audit tendering has recently been expressed by the Cadbury Committee (1992, p. 33). We introduce to the accounting literature existing knowledge of the *theory* of tendering from other disciplines and the *practice* of tendering from other areas of business activity and relate these findings to a series of interviews held with the finance directors of UK listed companies which had recently changed auditors (the majority via tendering). These interviews build upon existing knowledge, gained from questionnaire surveys and the analysis of publicly available secondary data, by providing a richer understanding of the actions, beliefs and perceptions which can combine to precipitate change.

The principal objective of this paper is to investigate empirically the auditor change *process*, especially changes arising from tenders. A subsidiary objective is to review relevant economic concepts and theory. These objectives are covered in sections three and two, respectively. In section two, general analytical tender models, developed in economics, are described. The assumptions and implications of these models are compared and contrasted and their relevance to the audit market is outlined. In section three, we present an analysis of the auditor change process derived from interviews with 12 UK listed companies which had recently conducted a tender and/or changed auditors. Quotations from interviews are included to support this analysis of typical audit tender characteristics. Discussion of these characteristics incorporates issues arising from section two. The final section summarizes and considers the implications of our findings.

**Literature review**

Tender theory forms part of the microeconomic analysis of auctions and bidding[3]. As a mechanism for effecting trades, auctions are an alternative to both posted prices and individual bargaining, with posted prices being suitable for standardized items. In practice, a combination of both bidding and bargaining over specifications are often employed in trades. Three basic types of auction are in use: "English" (open outcry, ascending bid), "Dutch" (open outcry, descending bid) and highest-price sealed bid.

A basic bidding model concerns the standard sealed-price auction where the lowest bid wins and where the bidders have no observably different characteristics (i.e., a *symmetric* auction). It is assumed that the bids made by competitors are statistically independent and that their distribution can be estimated from history (i.e., there is no unobserved common factor affecting all of the competitors' bids), and the bidder knows the amount that it will cost him to complete the contract (i.e., each bidder can ignore the others' information in forming their cost estimates). These assumptions are known as the *independence* and *private values* assumptions respectively. If $b_i$ is the bid of the $i$th bidder and $c$ is the cost of completing the contract, then it can be shown that expected profit is $P(b_i \leq b)(b_i - c)$, i.e., the probability that a bid of $b_i$ beats all other bids times the profits. In competitive bidding, $b_i$ should be selected to maximize this expression (Milgrom, 1989, p. 4). In symmetric environments, all types of auction described above are efficient and lead to the same expected revenues for the seller and expected profit for the bidder (Milgrom, 1989, pp. 9-10 and p. 16).

It is usual, however, for the actual costs of completing the contract to be a random variable, $C$, i.e. for the private values assumption to be invalid. An important result of bidding theory which emerges in this case is a phenomenon known as the *winner's curse* which describes the situation where the winner's bid is, on average, too low. To illustrate, assume for the sake of simplicity that $C$ is common to all bidders who each make independent estimates of $C$. Although the estimation errors are independent, the estimates themselves are not. Moreover, although each estimate remains unbiased, the lowest estimate is biased downward. Provided all bidders determine their bids by adding a mark-up which is positively related to cost, the winning bidder will be the one with the lowest estimate of costs and the winner's cost estimate will, on average, be too low (Milgrom, 1989, pp. 4-5). The implications of this are twofold. First, to make a profit it is necessary to mark up bids for both the underestimation of costs on the contracts won and a profit margin. Second, the returns in competitive bidding come from cost and information advantages. Studies of offshore oil leases find evidence of the winner's curse, although experimental studies suggest that experience can teach bidders to avoid it (Thiel, 1988, p. 284).

Another important theoretical result is that in *asymmetric* first-bid auctions (i.e. Dutch and standard sealed bid auctions where the bidders have observably different characteristics) the equilibrium allocation will not necessarily be efficient (i.e. Pareto optimal), in the sense that the bidder with the highest personal valuation (lowest costs) will not make the highest (lowest) bid and therefore will not win[4]. The theory makes no clear predictions about the outcomes in such cases.

Due to the mathematical complexity of auction theory, it is only very recently that attempts have been made to incorporate a *quality* dimension into the basic models (Cripps and Ireland, 1994; Ungern-Sternberg, 1994). Ungern-Sternberg (1994) has shown that there exists a commitment problem, in that the price-quality schedule which the buyer specifies *ex ante* may not reflect *ex post* preferences, since buyers' *ex ante* relative quality weight acts as an incentive for the bidders to invest in quality-improving up-front costs. Cripps and Ireland (1994) compare three tender designs which have a quality threshold which is not known with certainty by the bidders. In the first design, quality plans must be submitted and approved *before* price bids will be accepted. At the price-bid stage each bidder knows the number of bidders and their quality plans. This design reflects the case where "quality tests are largely a matter of the established reputation of the bidders" (p. 318). In the second design, price bids are submitted first to generate a ranking for quality review, with the first plan to satisfy the quality threshold being accepted. In the third design, price and a quality plan are submitted jointly. Cripps and Ireland (1994) model the symmetric, two-bidder case, measuring quality as the probability of passing the unknown and uncertain quality threshold. They find, perhaps surprisingly, that all three designs are equivalent in terms of expected profit and social welfare, although their analysis does not consider whether the winning plans will actually be required to be carried out. In the case of fixed-price contracts, the purchaser must ensure that the contractor does not act opportunistically, either by attempting to maximize profit by reducing standards without detection, or by attempting to renegotiate the contract in his favour. Tight control over both the specification and the enforcement of the contract are necessary (Walsh, 1991).

Laffont and Tirole (1991) introduce the concept of the *auction designer* – the individual who acts on behalf of the principal in organising the tender process. This agency relationship raises concerns that the auction designer may prefer, or collude with, a specific bidder, by either biasing their subjective evaluation of quality or distorting the relative weights of the various attributes to favour a specific bidder.

These theoretical analyses of auctions and bidding strategies provide a rigorous basis for the discussion of tenders in the audit context. Six conclusions emerge. First, since audits are not a standardized item, posted prices are not a suitable mechanism for effecting trades. It is, rather, individual bargaining that tenders have replaced in the audit market. Second, the use of tenders rather than individual bargaining by companies is a rational response to increased competition in the audit market, since bargaining is best avoided when there is enough competition for auctions (Milgrom, 1989, p. 19). Third, audit tenders are not symmetric, since audit firms have observably different characteristics. In particular, the big six/non-big six distinction reflects different perceptions of reputation, some firms are industry specialists, and firms adopt different audit approaches. Theory makes no clear predictions about the outcome of tenders in such cases. In addition, with the exception of listed company start-ups, college, local government and health service audits, there exists an incumbent auditor who has information and cost advantages over other bidders. This allows the incumbent to estimate his costs of contract completion more accurately than other bidders. The latest audit fee is, however, known to all bidders, and this can be viewed as a benchmark (similar to a posted price) which must, *ceteris paribus*, be undercut to obtain the contract.

Fourth, where the costs of contract completion are not fixed, the model results in an outcome where the winner is "cursed", in that their bid is too low. This may *partially* explain the lower audit fees observed post-tender. Rational responses by audit firms to lower fees or losses arising on tendered audit work would be to improve efficiency and/or to increase profit margins on other services to the client. The potential for cross-subsidization in the audit context is high, due to the existence of significant other fee sources (Peel and Brinn, 1993). Low bids may, however, also arise from competitive strategies (DeAngelo, 1981b), particularly strategies to establish a presence, or increase market share, in a specific market sector.

Fifth, as a consequence of the committment problem, it is difficult to identify favoritism in the choice of winner. Related to this issue is the current concern in auditing that the *de facto* control which executive management has in the appointment (and remuneration) of auditors presents a corporate governance failure. In the UK, the APB has recently proposed that "audit committees of listed companies should have specific responsibility, as a proxy for shareholders, for the appointment and remuneration of auditors" (APB, 1994).

Finally, a key feature of audit tenders would appear to be that the winning bid is selected on the basis of quality characteristics as well as cost, since quality signalling is an important factor in the audit process. In the audit market, the first tender design identified by Cripps and Ireland (1994) applies, in that the audit firm's reputation/size is used as an initial test of quality in the selection of tenderers, with the "big six" firms being seen as possessing a qualitatively higher reputation than other firms[5]. In the context of audit tenders, it has been established that the board of directors, especially the finance director, acts as the auction designer (Beattie and Fearnley, 1993).

Thus, in their current stage of development, economic auction models have four limitations for audit settings. First, the analysis of the more complex cases which incorporate a quality dimension are restricted to the symmetric case, which does not apply to audits. Second, the unknown, multiperiod nature of audits is an important added complexity. Standard contracts relate to a fixed term, whereas audit contracts are, legally, renewed annually, despite the shift towards audit fee agreements which extend beyond one year. In practice, it is usual for auditor-company alignments to continue for many years[6]. The unknown duration of the relationship is another complication which is difficult to model satisfactorily. Third, the costs of preparing a bid are largely ignored[7]. Finally, and most importantly, tenders commonly involve only two parties. Thus, in standard commercial contracts, risk (i.e., responsibility for service failure) is shared between the contractor and the purchaser. In the audit setting, however, there are three key parties: the audit firm (service provider), the board of directors (purchaser), and the shareholders (recipients of service). Company boards have no direct responsibility for audit performance failure, and in some circumstances may benefit from it where auditors have failed to detect directors' misdoings. Responsibility for the design and delivery of audit lies entirely with the audit firm. The risks associated with failure also lie with the audit firm (in the form of withdrawal of audit licences, professional disciplinary proceedings and, where a loss has been suffered, large claims and damaging publicity) and only affect the shareholders if the audit failure leads to financial loss. The boards of listed companies are able to minimize the risks of audit performance failure for their shareholders by recommending a large (big six) audit firm, size being a proxy for quality (DeAngelo, 1981a). If, therefore, all bidders can be taken to satisfy minimum quality levels and be financially stable, then the selection of a "winner" should, rationally, be price-based; provided a reputable audit firm is appointed this decision is risk-free for the company directors[8]. It may also be noted that opportunistic behaviour by the contractor is unlikely in the audit setting, given this risk distribution.

**Interview evidence**

The objective of the interviews was to obtain detailed insights into the circumstances surrounding the auditor re-appointment and change *process* (particularly focusing on tendering). Rich data on such issues cannot be elicited using questionnaires, which has been the method of investigation into auditor change most frequently used to date. Very little is known about how the audit tender and change process *actually works,* and the semi-structured interview approach allows us to focus on understanding the dynamics present within single settings. Since prior studies have shown that finance directors are the most influential party in both the audit appointment decision and the tendering process (Beattie and Fearnley, 1993; Hussey and Jack, 1994, p. 22), we focused on eliciting the finance directors' frames of reference, i.e. the structure of their choice decision and the forces and relationships which either create and sustain, or change, this structure.

*Methods*

Twelve UK listed companies which had conducted a competitive tender, changed auditors, or both between 1989 and 1992 were interviewed. Additional selection criteria were applied to ensure that a range of company size, industry sectors, audit firms, geographical locations and listing status were represented in the sample (Eisenhardt, 1989, p. 537).

Turnovers ranged from £6m to £4bn. Industry groups included engineering, distribution, foodstuffs, brewing, leisure and hotels, software, media, property, and financial services. Twelve audit firms were directly involved as gainers and losers, including five of the big six, three other top 20 firms, two top 50 firms and two small firms. Other firms were involved as tenderers. Company locations included London, the South Coast, the Midlands and Yorkshire. Nine companies were fully listed. Nine of the companies selected had conducted a competitive tender. All 12 finance directors agreed to be interviewed on the assurance that neither they, nor their auditors, would be publicly identified or identifiable. The characteristics of respondents' companies and their audit firms are summarized in Table I.

Interviews, which were one-to-one and (with one exception) conducted on the company premises, were all carried out by the same researcher who is a qualified accountant and experienced auditor. A relationship of trust was established with the interviewee by the confidentiality assurance and the common professional ground (all but one of the interviewees being a qualified accountant). The interviews were semi-structured using a small number of broad open-ended questions designed to bring to the surface directors' strategic thinking about the issues (other related issues were explored as they arose). Main topics (e.g., why did the company decide to change auditors?) identified from prior studies were formed into a question route, although flexibility was permitted in introducing these topics to improve the flow of the interview. Neutral, conversational prompts and a laddering technique, which involves

**Table I.**
Characteristics of respondent companies and their audit firms

| Case no. | Turnover | Industry | Tender conducted? | Tier of outgoing auditor[a] | Tier of incoming auditor | Geographical location of company | Audit committee | Listing status |
|---|---|---|---|---|---|---|---|---|
| 1 | <£50m | Eng.–vehicles | Yes (2) | Third | First; first | Provincial | Yes | Full |
| 2 | <£50m | Software | Yes | Third | First | Provincial | No | USM |
| 3 | >£50m | Engineering | Yes | First | First | London HO | Yes | Full |
| 4 | >£50m | Leisure & hotels | Yes | First | First | Provincial | Yes | Full |
| 5 | >£50m | Food | Yes | Second | First | London HO | Yes | Full |
| 6 | <£50m | Property | Yes | Second | First | London HO | Yes | Full |
| 7 | >£50m | Distributors | Yes | First | First | Provincial | No | Full |
| 8 | <£50m | Food | Yes | First | Second | Provincial | No | Full |
| 9 | <£50m | Engineeering | No | First | First | Provincial | No | Full |
| 10 | <£50m | Media | No | Third | Second | London HO | No | USM |
| 11 | <£50m | Brewing | No | First | Second | Provincial | No | Full |
| 12 | <£50m | Financial services | Yes | First | N/A: no change | London HO | Yes | USM |

**Note:** [a] First tier auditors are defined as the "big six"; second tier auditors are taken as the next 14 firms, based on the audit market concentration measures reported in Beattie and Fearnley (1994, p. 310); third tier firms are all other firms asking "why" and "with what consequences", were employed as necessary. Each interview lasted between one and two hours and all were tape-recorded and subsequently transcribed in full for further analysis (Jones, 1985).

Interview transcripts were content analysed: a coding scheme was developed (Strauss and Corbin, 1990, pp. 57-74) and themes (or categories) identified from the data. A summary from each respondent's interview was prepared to assist within-case analysis. These summaries were then tabulated using the identified themes, forming a matrix display and facilitating the search for cross-case patterns (Miles and Huberman, 1994; Strauss and Corbin, 1990, ch.10).

The remainder of this section summarizes the results of this analysis of the auditor tender/change process as described by the interviewees. The process has been divided into five chronological stages: the reasons for change (which provides the tender context), the choice of firms invited to tender or accept appointment, the organization of the tender process, the choice of new audit firm, and the after-effects of the change. Individual sub-sections cover each stage. Quotations from the interviewees, edited to preserve confidentiality, are included throughout to support the findings. A summary of the key issues identified by interviewees at each stage of the auditor tender/change process is provided in Table II.

### *Reasons for change*

A total of 23 distinct reasons for auditor change were cited by the interviewees, of which nine were attributable to sudden or gradual changes within the client company. In two cases new management had put a number of services out to tender, including audit, to test the market and ensure value for money. There was, therefore, no definite intention to remove the incumbents. In two cases the decision to rationalize the group's auditors prompted the change, while in another case the company adopted a policy of putting professional services out to tender. Expansion or change in corporate activities was a reason for change in three cases, as companies sought *the extra dimension of business advice and guidance* (case 2), *special transactions* capabilities (case 6), *with an international scope* (case 10). One company succumbed to pressure from its non-executive directors to appoint *an auditor that was more of a known name in the City* (case 1). The remaining 14 reasons for change, however, involved specific problems with the current auditor. These problems related mainly to audit staff and quality issues, rather than fees. Excessive audit staff turnover was cited in two cases:

> we were getting new articled clerks… so they were having to be led by the hand through the procedure every year (case 1)

and

> … except for the managing clerk… I don't think we saw the same face in here three years running… to change [the audit staff] every year is very traumatic… because people have got to be taken round the factory, shown all the routine, shown the internal audit steps again – it's a problem… we've had instances where you've had the same question asked in a different guise in three different ways (case 8).

**Table II.**
Key issues at each stage of the auditor/tender/change process

| Case no. | Reasons for change | Choice of firms invited | Organisation | Choice of new audit firm | After effects |
|---|---|---|---|---|---|
| 1[a] | 1. Regional partnership split; pressure from non-executives for big firm<br>2. Cross-subsidization; staff turnover; lack of internal control review; flexible on accounting policies | 1. Non-executives wanted B6; other board members felt second tier better size match<br>2. B6 only due to perceived City pressure | 1. Verbal<br>2. Approx 100-page pack of audit requirements; visits; requests for written tender | 1. One out for poor pres'n and quote too low; second tier firms out as quotes higher than 1st tier; then "chemistry"<br>2. One out due to IC view; one out as partner quit; incumbent out as stuck to 20 per cent discount; left only one | 1. Unsatisfactory, so tendered again<br>2. Chemistry good |
| 2 | Growth caused need for extra advice and guidance; distance from auditor too great | Big firm wanted due to new listing status; local office | Prepared questionnaire covering what auditor was to say; fixed term and price | All stressed constant partner access; presentation showed all capable; not fee-based; who had steepest learning curve; prior contact | Documentation improved; after three years run on again; then will to get fresh views |
| 3 | Merger created two firms so rationalized | Two incumbents | Presentation to AC and glossies | One presentation more focused on issues not fees; communication and personality; personal contact with Chairman | Three year fixed-price caused fee disputes; scope review |
| 4 | New management wished to reduce accountancy work and improve profitability | Four of B6 (two out due to litigation links) | Presentation | Style/personality; no difference in ability to perform function | Happy – no further change anticipated |

(*Continued*)

| Case no. | Reasons for change | Choice of firms invited | Organisation | Choice of new audit firm | After effects |
|---|---|---|---|---|---|
| 5 | Rationalization process | Three existing firms (+ one unsolicited not considered) | Questionnaire to operating companies | One out based on ques. responses; one out as poor overseas capabilities; not fees; left one | Stable unless unacceptable fee rise; change raises doubt unless reason; sh's liked fee cut |
| 6 | Integration with US led to need for B6 who have special transactions capabilities and high reputation for City and third parties | Incumbent + 2 B6 known through business contacts | Specification documents prepared; US and UK both reviewed tender documents | One out as document standard; others focused on specific needs; not fees; not personalities | – |
| 7 | New management sought VFM on all professional services; change in attitude to costs | Incumbent + 1 B6 based in company's location | Written quotes | Based on fee; no difference on service offered | Satisfied |
| 8 | Policy adopted to tender professional services; underlying problem staff turnover led to time costs and they didn't understand business; dissatisfied with audit quality | Top tier – req'd for competent plc audit and VFM; size match required, so not top two or three | Shown round all businesses; was time consuming | Personalities and then location; fees all same; incumbent out as quoted below current fee | No benefit in year 1; comes in yrs 2 and 3 |

*(Continued)*

**Table II.**

Table II.

| Case no. | Reasons for change | Choice of firms invited | Organisation | Choice of new audit firm | After effects |
|---|---|---|---|---|---|
| 9 | Accounts of acquired company did not disclose liabilities; gaps in financial controls | One only – recommended by Chairman's colleagues/ contacts | N/A | N/A | – |
| 10 | Temporary partner replacement too old; looking to set up overseas so no need for international scope | One only – personal contact of non-executive; *not* B6 | N/A | N/A | – |
| 11 | Incumbent mishandling of corporate finance advice | One only – had impressed Chairman during an acquisition | N/A | N/A | – |
| 12 | New auditor had shown off; fee dispute; didn't understand business | 4 B6 and 2 second tier | Briefing meeting with FD | B6 out as had specialist teams, so extra fees for advice; secondment to regulators, so lack of secrecy; but non-exec. unhappy with non-B6, so decision deferred | N/A as no change |

**Note:** [a] This company changed auditor twice. Abbreviations: B6 – big six; FD – finance director; AC – audit committee; pres'n – presentation; sh's – shareholders

One company's board decided, without discussing the problem with the incumbent, to change auditors because they felt that the partner who was standing in during the engagement partners' illness was too old:

> … most of the directors of this company were sort of early forties or younger and we got this partner in his sixties and he had, sort of, no knowledge of the company, no interest in us, and nothing really we could get on with, and we found when we were sitting around at meetings, we'd all be quite young – solicitors all quite young and the merchant bankers were quite young and you had these two old men from [third tier firm] and we thought "this is getting silly" (case 10).

Another company were simply unimpressed by their allocated partner:

> …he didn't really understand the industry, he was always very late with providing us with information – returns for regulators tended to have to be biked at the last moment' (case 12).

Six reasons relating to the professionalism and competency of the audit firm were identified. One company objected to the fact that their auditor wasn't "…interested in doing internal controls… all of a sudden we went to a full balance sheet audit" and was "…encouraging us to look at slightly more racy accountancy policies" (case 1). In one case the existence of "substantial undisclosed liabilities" in a company acquired "on the basis of the published year-end accounts" and audited by another office of the same firm, combined with "serious gaps in financial reporting controls" (case 9) led to the auditor's replacement, while in another case replacement resulted from the chairman's dissatisfaction with the quality of corporate finance advice received on the disposal of a subsidiary:

> [the auditor] didn't act quickly enough in the eyes of the chairman and didn't give…sufficient or accurate advice…they upset him – bang, off you go chum! (case 11).

In another case the problem was that the auditors

> showed off when they got our business [by] making it known that they'd got it before we'd actually officially awarded it to them…my chairman…felt that this was very much a breach of confidence (case 12).

Subsequently, one of the company's regulators intimated that the audit firm didn't appear to understand their client's business. Fees were a contributing factor in only two cases. In one case, suspected cross-subsidization was the problem – incoming auditors had "cut their fee rate by 20 per cent to get the job and they were expecting to be able to cover that from other types of fees throughout" (case 1), while in another company a dispute arose when, without prior discussion, the fee greatly exceeded that quoted, due to additional accountancy work being undertaken (case 12). Finally, the split of a regional audit partnership into individual local offices "wasn't acceptable" (case 1) to one company, while a distance of 100 miles from its auditor ultimately proved unacceptable to another:

> the senior partner there who dealt with our affairs…used to have round-up meetings that he always scheduled on his way to [coastal town] because he had a flat in [coastal town] and you know whilst that was understandable from him, it isn't quite the sort of response that we

> want. I mean, if we want a meeting, we want to diarise when we want it and not quite, you know, if he's going down to [coastal town] (case 2).

Twenty-six factors which could lead a company to consider changing its auditor were identified by Beattie and Fearnley (1995), with level of audit fee, dissatisfaction with audit quality (i.e. auditor's ability to detect problems) and changes in top management being the main reasons, cited by, respectively, 49 per cent, 41 per cent and 35 per cent of the actual auditor changers within the sample. The interview evidence presented here, however, suggests that issues relating to change within the company and the auditor's professionalism and competency are the most frequent change drivers, with fees being a less frequent change driver. Fees appear to precipitate change only when they breach acceptable tolerance limits and were seldom identified as the *only* change driver. (We suggest that if fees are the sole reason for discontent it would be cost-efficient for both parties to negotiate a reduction rather than engage in a costly tender and change process.)

### *Choice of firms invited to tender or accept appointment*

In the three cases where no tender was conducted, the client-auditor relationship had broken down (see Table II, column 2, cases 9, 10, and 11). The chairman chose the replacement firm in two of these cases, instigating enquiries through personal contacts to find an audit partner of good reputation in a local office in one case. In the other case the chairman was more impressed by the corporate finance performance of the firm acting for the other side in an acquisition although their office was a considerable distance away, so they were appointed. In the third of these cases, the board had decided against the big six and an approach was made through a contact between a non-executive director and a corporate finance partner in a top 20 firm.

Where tenders were conducted, it had to be decided which firms to invite to tender. Three smaller companies expressed reluctance to invite the very largest firms on the grounds of size match:

> we believed that we would be better off in the ten to twenty range…where…their size matched our size (case 1),

> we felt…we were too small a fish in a great big pond to get the service that we wanted (case 8),

and

> there was a much better match between the size of our organization and their organization (case 12).

A related reason for selecting a second tier firm was expressed by one of the non-tendering companies:

> although we were on the USM, which counts for Brownie points in the rankings, we thought we were probably at the back of the queue for any good staff or any good advice in a big firm.

In eight cases, however, the board (especially non-executive directors) specifically wanted a top (normally big six) audit firm in order to have "an auditor that was more of a known name in the City" (case 1) and with the required scope and expertise. No differentiation between the big six firms was generally made.

An important finding was that the majority of companies expected audit firms to offer more than audit services. For example:

> We want, obviously, an efficient audit, but we also want the add-ons (case 6),
>
> We were very keen to see what…total solution they could provide (case 2),
>
> If we're making acquisitions or investment they [the audit firm] by nature get involved (case 5),
>
> We'd obviously use them [the audit firm] for anything to do with the City basically (case 8)',
>
> The more important area of work we use the audit firm [for] is due diligence and corporate finance work on acquisitions (case 4).

This finding is reinforced by several of the reasons for change cited above: the need for business advice, special transactions, and concerns over perceived cross-subsidization. A number of other choice factors emerged, though with less frequency. For two companies located outside London the location of the firm was important, consequently only those with local offices were invited. Where auditor changes resulted from rationalization, only the incumbent firms were invited. In another company, two firms were expressly excluded because they were either the subject of, or were acting as expert witness in, "ongoing litigation" (case 4). Incumbent firms were in all cases invited to tender, although in one case the firm refused whilst in another they weren't seriously considered.

The interview evidence shows that, in general, the choice of firms invited to tender initially arises from specific requirements by listed companies for either a big six firm (to signal quality) or a second tier firm (to obtain size congruence). This demonstrates that audit firms do have observably different characteristics and hence that audit tenders are not symmetric. Although the reputation and range of services provided by big six firms was universally recognized, and provided a preliminary quality filter, several smaller companies preferred, for behavioral rather than economic reasons, the size match with second tier firms[9]. It is notable that none of the companies was, at this stage of the tender process, seeking an audit firm which specialized in their industry.

Within these class constraints, the selection of firms invited to tender is based on factors such as location, personal knowledge of individuals or firms and the wish/perceived need to exclude certain firms. These selection factors (i.e., audit firm class, proximity of office, personal contacts, and specifically excluded audit firms) resulted in considerable variation in the number of firms invited to tender (ranging from two to six). Conflicts of interest, not directly connected with the audit appointment, which led to firms being excluded from tendering included ongoing or potential litigation and secondment to regulators. Such conflicts are a direct outcome of the limited number of accountancy firms operating in the listed company market, each offering a wide range of services and highlights the problems associated with a rising level of audit firm concentration, and the resulting limitation of choice. In addition, the interviewees did not distinguish between the legal appointment of auditors and the engagement of the audit firm for NAS.

### *Organization of the tender process*

In all cases the finance director was heavily involved in at least the early stages of the tender process. The general pattern in the nine tender situations involved the receipt of written quotes by invited firms followed by oral presentations to the full board, the audit committee (cases 1 and 3) or some other senior management group by those shortlisted. This was preceded by a briefing meeting with the finance director in one case and factory visits in another two. Only three companies issued a detailed written specification of their requirements. This may be because the audit *per se* is defined externally and the audit process is outside the directors' control. It may also be that audit firms are, for the reasons discussed above, unlikely to act opportunistically, rendering tight control unnecessary.

In one case, the specification was based on lessons learned from an earlier tender and comprised approximately one hundred pages of:

> the audit requirements we were looking for, the sort of documentation we would expect to give them, the timescales of when we would expect them to come in, have the audit finished, consolidated…when they could expect printers' proofs…the type of audit that we were looking for – the fact that we were not happy with just having a balance sheet audit, that we wanted an audit that covered internal control, if only on a rolling basis…we stressed that fees were not a problem to us…we wanted…to make sure it was the right quality of audit or the right relationship…we wanted them to understand that there were no other fees there and if any other jobs did come along that…we were quite likely to put them out to tender (case 1).

As discussed above, in general the tender *process* related implicitly not just to the audit attest function, but to a larger package of services relating to the annual financial reporting process, and to the availability of other, less regularly recurring, services. Despite this, the quoted fee relates exclusively to the audit. Thus a range of services was being bought and sold through the tender process, of which the legal audit formed only a part. The audit firms were therefore expected to present themselves on the basis of all the services they could offer. This also enabled the directors to distinguish more easily between firms.

In at least one case, the specification invited bids on the basis of a fixed-term, fixed-price contract, while in another the contract duration and fee was set at the time of appointment. It may be noted that fixed-price contracts are common in both of the industries represented by these companies:

> what I do welcome is that they don't go on this time and materials rubbish…we do a lot of fixed contract work…it's not so much the fixed price, it's the commitment…it's sharpened us up and I don't see why solicitors, accountants and bankers should be any different (case 2).

It appears that companies are attempting to treat audit services as a standard commercial contract, despite the fact that auditors (especially non-incumbents) cannot know *ex ante* the amount of work necessary to form an opinion.

Six of the nine companies which tendered had an audit committee, in each case chaired by a non-executive director (see Table I). This appeared to affect the influence of the finance director (auction designer), in terms of their involvement with the five stages of the tendering process (initiation of idea, invitation of bids, attendance at presentations, evaluation of bids, and final decision). In the three cases where no audit committee existed, the finance director was involved in *all* stages (with the minor exception of one case where the idea originated elsewhere). Where an audit committee did exist, however, the finance director was *not* involved in the crucial final decision stage in three cases (50 per cent). In these three cases, either the audit committee or the audit committee chairman (or both) were involved in the final decision. Thus the influence of the finance director is reduced by the existence of the audit committee.

A further issue highlighted by the tendering process is the period of appointment. Normally, a contract awarded by tender would be both fixed-price and fixed-term. An audit contract is legally renewed annually, yet in two cases fees were agreed between directors and auditors for a fixed period (providing further evidence of the ineffectiveness of the shareholder appointment procedure). An indefinite period of appointment (where the auditor does not know how long the appointment will last) sits uncomfortably with competitive tendering. In two cases new auditors were quickly dismissed, almost on a whim, for reasons which would not legally need to be drawn to the attention of the shareholders.

### *Choice of new audit firm*

There were a variety of reasons for eliminating firms early on (i.e. often before the oral presentations) in the nine tender situations. In two cases poor written quotes were cited:

> it showed that they had not looked and understood the group (case 1)

while a female finance director was irritated by

> a standard presentation chopped about a bit for us. I mean they'd even addressed the thing "dear sirs", when, you know, you'd think they'd have the courtesy to look to see who was on the board. The others had taken a bit more time and care with it.

In one case, a big six firm

> did not believe that they ought to do an audit on internal controls…they failed to understand that it wasn't necessarily Cadbury or the Institute that was driving us (case 1).

One company developed a questionnaire that each operating company completed following visits by the audit firms, which were judged "on the way they asked their questions about what they were trying to find out, …their knowledge of the business and their… charisma" (case 5). This appraisal resulted in one firm's rating falling significantly below the others. Another firm (the incumbent) was eliminated because of inadequate overseas support. In the case of a financial services company, subject to heavy regulation, all the big six firms invited to preliminary discussions were eliminated because of concerns about their relationship with the regulators:

> they have a policy of seconding their personnel to the regulators… we do not like our business being discussed behind our backs which is inevitable in this system (case 12).

Fee issues emerged in three cases only. One company considered a quoted audit fee to be too low, which led to doubts concerning the quality of the firm's work, and others to be too high relative to other quotes received. In another case the incumbent auditor quoted 20 per cent below their current fee. When asked to justify the reduction, he effectively eliminated his firm with the ill-judged remark:

> "I didn't realise I'd got to be competitive" …that was the final nail in the coffin, that comment, particularly when I repeated it to my board members (case 8).

The financial services company was concerned about possible future cross-subsidization attempts and fee disputes with big six firms arising from the existence of specialist teams formed within these firms:

> we have a number of specialist points which we wish to raise… and we would be very quickly involved in a fairly hefty fee from the specialist department… the contracts which are now drawn up by the large audit practices are so tightly drawn that anything which falls outside it would fall outside the terms of the contract and one would be in acrimonious position from day one when talking about fees (case 12).

Only in one case was a shortlisted firm positively eliminated. This occurred because

> unfortunately one of the partners that had been involved in doing the tendering investigation had quit… [the presentation] came badly unstuck on the day. They didn't really know what they were talking about; they kept getting the subsidiaries mixed up (case 1).

In general, however, bases on which to discriminate between the shortlisted firms had to be found. In several cases, respondents expressly commented that potential bases (access to partner, ability, service, personalities, fees) were not used: "complete access [to audit partners], which we think important, was stressed by all firms" (case 2); "I would have expected them all to fulfil the function of auditor very well" (case 4) and "there wasn't really any difference in what the two firms could provide for us" (case 7); "it wasn't the personalities" (case 6). In total, six of the nine tendering companies did not base their decision on fees, either because the quotes were very close or because fee level was within the acceptable range. For example:

> so it went down to those two and [big six firm] got it – not on price, although they were the cheapest as well (case 1),

> fees were remarkably similar with the exception of [big six firm] who were the dearest by quite a higher percentage… they certainly weren't knocked out on a cost basis (case 2),

> the fees quoted were extraordinarily close… so it wasn't decided on fees (case 3),

> in fact we didn't go for the cheapest quote (case 5).

The bases on which the final choice was made were: chemistry "on the basis that… the chemistry between their team and our team was the best chemistry" (case 1); personality/communication "the decision… was done on personality and communication" (case 3) and "at the end of the day it comes down to personalities" (case 8); prior experiences of the firms' performance "[big six firm A] presented nothing in writing to the board other than the actual accounts… [big six firm B] produced a thirty- or fifty-page statement of the major judgmental issues, major internal control points… extremely good communication" (case 3); presentation detail "[big six firm] were very focused… tailoring [the presentation] specifically to our needs" (case 6); geographical proximity "it was the location that was the ultimate" (case 8); fees "we're desperately trying to reduce our overhead base… we couldn't ignore the difference [in fees]" (case 7); learning curve "in the end it was down to who we thought could get up speed quickest" (case 2); and personal contacts "we had some contact with [big six firm] in the past… the audit partner seemed to take an interest and wanted to get involved and at that time was not receiving any fee at all" (case 2) and "really, because the chairman knew the [big six firm's] partner that was it" (case 3).

Given the frequent similarity in bid fees, it was rational for selectors to focus on other factors in making the final choice. In the case where the final choice was fee-based, it was considered fortuitous that the change also involved the replacement of "straight-laced, maybe more formal, much more serious" people with a more "affable bunch of people":

> You know when the [big six firm's] man walks into the room that you're 90 per cent sure he's going to be a serious sort of individual who probably won't crack a joke with you for instance. Whereas you can be 90 per cent sure that the [another big six firm's] man would be the other way around, you know. He will be very affable, he'll smile (case 7).

The general picture to emerge from the interviews was that audit fees were an important influence on choice only where the quoted fee fell outside acceptable tolerance limits for what was believed to be the market price for the job. For example:

> as long as the fee is within what I feel to be the market rate for the job (case 8), and

> I felt it was necessary to test the market and find out what the price should be (case 4).

The audit fee did, however, surface as a primary *driver of change* if companies felt that fees broke acceptable tolerance limits (see later sub-section on after effects of the change). Interestingly, companies were less aggressive negotiators when purchasing NAS, which were more widely perceived as adding value to the company. For example:

> we will take a different view of the audit fee to that of professional advice (case 11),

> due diligence and corporate finance work on acquisitions… that's where we get genuine value (case 4), and

> negotiated less on special transactions – added value to company (case 6).

Thus, the choice of auditor in tender situations is not based solely on either fees (as, it has been argued, would be expected, given the distribution of risk associated with audit failure among the parties concerned), or the expected quality of legal audit provided to the shareholders, but rather on factors such as the range and quality of NAS (economic factors) and expectations regarding the quality of future relationships (behavioral factors). An interesting finding was that an error of judgment, a foolish remark, or a silly mistake at any time during the tender process was likely to rule a firm out, with some firms showed a remarkable ineptitude in this respect. This again demonstrates the importance of behavioral, in addition to economic, factors.

*After effects of the change*

Four companies expressed satisfaction with their change of auditor. The main problem arising from changes was actual or expected fee disputes. For one company, the decision to change auditors for a second time arose because the audit firm admitted having underbid and was believed to be attempting to recover its losses by overcharging on other services provided:

> there was always this big pick between us which was fees. They had, of their own saying, cut their fee rate by 20 per cent to get the job and they were expecting to be able to cover that from other types of fees throughout… if we had a requirement for an insurance certificate signing… we would get the signature back with a bill for £500 (case 1).

In another case, fee problems were expected to arise at the end of the current fixed-price contract term:

> fees… is frankly an embarrassment… we don't want an increase, we want a reduction and they want an increase… the fee went down about 30 per cent, they are looking to increase it significantly – like 50 per cent. I think the relationship will change because of that. (case 3).

This anticipated problem had led to a review of "the scope of the work that they do, to see whether we can jointly eliminate some". In a third case the auditor had complained about agreed fee levels

> they've said that they've lost a lot of money on a fixed deal (case 2)

(despite this a further fixed-price contract was successfully negotiated). A further company thought that they would only change auditor again

> if there was an unacceptable continual rise in fee structures which made us feel that we were not getting an effective price competition (case 5).

Our explanation of the fact that price is the issue most frequently referred to following appointment is twofold. First, directors interpret the accepted bid as representing the market price for the job, thus subsequent audit fee increases following appointment often exceed acceptable tolerance limits. Second, fee disputes impair the quality of the working relationship between the auditor and the auditee. Thus price and non-price factors are not always independent.

A concern arose in two companies about differences in audit approach from the previous firm. In particular, the auditors were spending less time looking at internal controls:

> although [the subsidiary directors] moaned and complained about this management letter they got each year, that said that certain expense vouchers had been found not to be signed, they themselves had felt comfortable that they were having a full check on their work… the comfort that is gained from an internal control audit is worthwhile (case 1), and

> it has worked extremely well with this proviso that it has become an examination of material figures only and a disregarding of the detail – I'd say dereliction but that's too critical (case 3).

Case one also had concerns about the pro-active role that the new auditors were taking on accounting policies:

> there were these people coming to us and saying, "well, you are too clean, you don't necessarily have to have this accounting policy"… they stopped doing that after the first year to eighteen months because they realized it wasn't in our nature and, of course, the recession was starting to bite.

There were also perceived benefits arising from the auditor changes: "I know the shareholders were pleased that we cut our audit fee" (case 5), "[the audit firm] tell us where their concerns are… at an early stage" (case 3) and improved accounting records "because we demand a lot from [big six firm]… we can't give them a scrappy piece of paper with a few figures on… we've got to give them proper schedules… and full backing documentation… and that's bloomin' good for us" (case 2).

One company was reluctant to change again (unless forced to by fee rises) because "it just raises doubts in people's minds unless there is a very good reason for it" (case 5), whereas another finance director felt that, having just agreed to the incumbent's proposal for a further three-year, fixed-price contract, subsequent change thereafter was desirable "if you get too comfortable… you don't have those fresh views" (case 2). Interestingly, one finance director felt that current proposals for partner rotation would be "detrimental… to an ongoing relationship" and lead to "a lot more tenders" (case 4).

In all cases where tenders were conducted the prices quoted were below the last price paid, and, given the switching costs in the first year, all bids would also meet DeAngelo's strict definition of lowballing, assuming the incoming and outgoing auditors face the same cost structures and offer the same audit quality. We suggest that the market is experiencing a widespread lowering of price in response to fierce competition and that all switching costs are now absorbed by audit firms. In the absence of information about firms' costing and pricing strategies it is not possible, however, to assert categorically that audits are being performed below cost beyond the first year.

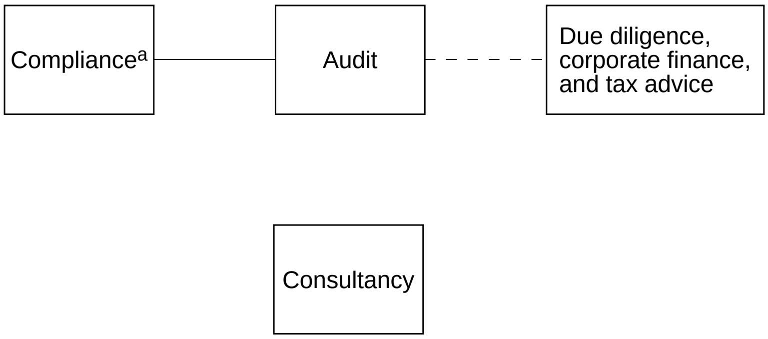
The cases provide some evidence of efficiency gains arising from the increased competition within the audit market. Fee reductions have been achieved, with audit firms claiming greater efficiency in their audit work (Brindle, 25 May 1995), although this is accompanied by tighter specification of contractual terms. In addition, companies are improving their own accounting procedures and providing better information to their auditors. Fee pressure has, however, also led to other changes which may not be beneficial. In only one case was an appointment made solely on the grounds of price. A key finding is that three examples of the "winner's curse" were identified, where the successful firm had bid low (although not necessarily much lower than other tenderers). As a result, there was blatant overcharging for other services in one of these cases, (which led to the removal of the auditors after three years) and attempts to renegotiate the fees in the other two. These consequences, although predictable where low bids have been made, were clearly resented by directors. In all three cases concerns were expressed by the interviewees that arguments over fees had undermined (or would undermine) working relationships. The quality of the working relationship appeared to be of particular importance to the directors, possibly because this was a primary basis on which the audit firm had been selected in the first instance.

These findings suggest that there is a need for variation clauses or the renegotiation of terms, such as occurs with standard commercial contracts, to become acceptable in the audit context to cover unforeseen audit problems. If not, then cross-subsidization by auditors from the client's other fees is likely to occur in their efforts to improve margins (a response not generally available to contractors in standard commercial contracts).

Another response by the audit firms to fee pressure was to change audit methodology. The focus is now on high risk areas, analytical review and the balance sheet, rather than on the time-consuming detailed examination of systems transactions and low risk areas. Although this may be a more efficient and cost effective way of reaching an opinion, reviews of internal controls have been much reduced. Assurance on internal controls was perceived by several interviewees as fundamental to the quality of the audit process, providing benefits to both the company and to the directors (possibly an alternative to the cost of internal audit) although not strictly necessary to the reaching of an audit opinion. This may have interesting implications for the implementation of the Cadbury proposals on internal control, since further fee disagreements can be expected to result from additional costs arising from work which some companies may believe is already being performed.

The tendering process has contributed to the perception that the purchase of an audit is no different from the purchase of any other service. The unique features of the audit function have become submerged by competitive pressures and companies' need, in the present complex regulatory environment, for advice on the preparation of the annual report and other matters. This advice has varying degrees of separability from the audit function *per se*, as shown in Figure 1. Directors clearly believed that the availability of NAS added value to the audit process.

It would appear that audit market competition has led to a dilemma over fees. It is, of course, properly part of the directors' fiduciary duty to obtain value for money for the shareholders, who delegate the responsibility for agreeing audit fees to the directors at the AGM. The audit fee is a single disclosed figure in the published accounts, and as a result it receives excessive attention in relation to its materiality, with a reduction being used by directors to signal good stewardship to the shareholders. Now that the total fees payable to the incumbent auditors are also disclosable there may be a case for segregating the




**Note:** [a]Including tax compliance and Stock Exchange circulars.

**Figure 1.** The degree of separability between audit and other services provided by the accounting firms

recurring compliance costs or including them in the audit fee so that the value of separable non-recurring services may be identified. Some of the outcomes of low audit fees may not, however, be in the best interests of the shareholders, with the directors themselves (although wanting fee reductions) expressing discomfort with the predictable behavioural outcomes from low pricing. This dilemma was expressed clearly by one interviewee:

> From a shareholder's point of view (and that's really what the audit is there for) it's a question of whether the shareholder gets value for money and the company paying for it… you know the shareholder has to be protected against malpractice… but as a director and looking for value for money in terms of added value to the running of the business, which is a different question altogether… the least cost is the best cost (case 4).

One victim of the "winner's curse" emphasized the weaknesses in the tender process:

> What we have found is that value for money is so very difficult to judge on a tender process and the old adage that the cheapest is not necessarily the best has come through loud and clear… I am not sure the quality of audits can be judged by the name… the city were getting a better audit of us by the local firm… because that firm was putting a lot of man hours into checking us over (case 1).

## Summary and conclusions

This study focuses on the audit tender process. Tender theory grounded in the economics literature is used to appraise the relatively recent developments in the market for audit services, which are illustrated using case analysis of 12 auditor changes, including nine competitive tenders. Consistent with theory, audit tendering as a mechanism for effecting trades appears to have arisen as a rational behavioural response by companies to the recession and the effects of competition. In symmetric environments, all common types of auction are efficient and lead to the same expected revenues for the seller and expected profit for the bidder. Where each bidder's costs of contract completion is a random variable to be estimated, however, the winner is "cursed" – a result which may partially explain observed lowballing. In addition, winners may, rather than make a cost estimation error, *intentionally* bid low. This may be the rational competitive response by the incumbent to capture expected quasi-rents on subsequent audits (DeAngelo, 1981b), or it may be a strategic response to gain market share or establish a "presence" in a specific industry sector.

Formal analytical tender models which predict the "winner", revenues, and profits are, however, of limited value in the audit context, which is characterized by asymmetry among the bidders, uncertainty with respect to contract duration, and quality (in addition to cost) as a key choice issue. The complexity of the environment in which audit tenders are conducted can be expected to affect bidding behaviour in subtle ways, making the development of a satisfactory theory of audit tender very difficult.

Economic theory predicts that, in audit settings, the selection of a winner will be price-based, since the choice of a reputable firm ensures that directors can demonstrate that acceptable quality thresholds will be met. Since, in most cases, bids were relatively close in terms of price, our empirical results do not provide a powerful test of this price hypothesis. Subsequent attempts by the winning firm to increase fees do indicate, however, that the winning bid was too low, a finding which *is* consistent with economic theory. Many directors appear to view the tender process as relating not exclusively to the attest function, but to a larger set of "audit-related" services (and possibly also non-audit-related services). Despite this, the tender quote relates exclusively to the attest function. We argue that the attest function is no longer effectively separable from certain other services related to the external financial reporting process. Directors clearly believe that the availability of NAS adds value to the audit process. As a consequence, directors' choice of auditor is *not* generally based solely on price. Directors choose an audit firm which they believe can best meet the company's specific needs with respect to both audit and NAS and with whom they feel they can establish the most satisfactory working relationship. Thus both economic and behavioural factors influence auditor choice.

In common with comparable three-party contractual situations, there is prima facie evidence of efficiency gains in the form of technical improvements, the improvement of corporate accounting procedures, and (possibly) lower audit fees. We have no clear evidence that the process of reaching the legal opinion has been compromised by tendering and associated fee reductions, nevertheless the added value of the audit process may have been diminished in some companies where, for example, internal control reviews have ceased. We do, however, believe that economic dependence may have increased because competition has made the replacement of lost clients more difficult and expensive.

Concerns that the provision of NAS by audit firms may threaten independence have led to calls that such provision be prohibited. We question, however, the possibility (or indeed desirability) of separating audit from other audit-related services, since this could threaten the quality of the financial reporting function. If such a prohibition were to occur, the potential for cross-subsidization from other fees paid by the client would be eliminated. A general policy of lowballing would become unfeasible unless cross-subsidization was shifted onto fees paid by *other* clients and/or the additional costs associated with unforseen audit problems were covered by variation clauses or led to the renegotiation of terms, as occurs in standard commercial contracts. Certainly tendering procedures, if not the contracts themselves, are becoming more sophisticated, as evidenced by the procedures adopted in the one case where a *second* tender had been conducted.

Auditor choice is clearly a multidimensional decision, contingent upon each company's specific circumstances. Ideally, companies would want high quality audit and non-audit services (including internal control evaluation), good relationships, and value for money. Where no firm ranks top on all of these dimensions, complex trade-off are made. Our findings reveal the influence of price versus non-price competition within the external audit market. The three principal dimensions of non-price competition appear to be: audit quality, quality of NAS, and quality of working relationships. The relative importance of each dimension, and each form of competition, is found to vary across companies. High fees were a contributing reason for change in only two cases and in only one case influenced the final choice of new audit firm. Given the frequent similarity in bid fees, it is rational for choice to be based on non-price factors. The main problem arising from changes was, however, actual or expected fee disputes, since companies are generally anxious to be seen to obtain value for money. Competition, through the tender process, has apparently established a "market price" for each audit. Incumbents who move outside fee level tolerance limits damage the auditor-client relationship and risk replacement.

Our findings support the concerns of Sir Ron Dearing in the UK, who believes that the auditor's position is weakened by existing appointment procedures, whereby directors can appoint, remunerate and dismiss auditors with little risk of challenge (FRC, 1991). The risk- free nature of the audit appointment for directors, combined with competitive pressures, may have shifted the balance of power in favour of directors. Our interview evidence indicates clearly that directors view auditor appointment as being in their hands and largely for their (not the shareholders) benefit. In the UK, the APB (1994) has proposed that audit committees take specific responsibility for such matters, whereas ICAS (1993) has proposed that an Audit Review Panel, completely independent of the directors, take this responsibility, thus removing the absolute control which directors have over the whole process. An interesting alternative solution would be that adopted in Italy, where auditor changes by listed companies (and the related fee) require approval by their regulatory body (CONSOB). We believe that there may be a case for recognition of the *de facto* position that auditors are appointed by directors and for their position to be protected by fixed-term, say three or four year, appointments, although this could bring the risk of more tenders on each re-appointment and increase fee pressure.

In sum, the efficiency of current tendering arrangements as a mechanism for effecting trades in the audit context is called into question, in particular because of the power of the directors, the balance of risk borne by them, the inclusion of other services (some of which are inseparable) in a bid where only audit is priced, the uncertain duration of the contract, and the possibility of cross subsidization if a loss making bid is won.

The findings of this study suggest that further research in this area is warranted, particularly in-depth, case study analysis of audit tenders which contextualize the evidence collected and compare and contrast the perspectives of different parties. Additional areas of research would be a more systematic study of the long term effects of auditor change (distinguishing changes via tenders from other changes) on fees and a deeper exploration of the auditor-director relationship. Of particular interest in the latter area is the directors' apparent need for a continuing good relationship with their auditors and the perceived threat that bargaining over fees presents to this. This relationship, and the effects of competition on independence, quality, and pricing strategy, should also be explored from the perspective of the audit firms:

> *The Comptroller and Auditor General shall hold office during good behaviour, subject, however, to removal therefrom by her Majesty, on an address from the two Houses of Parliament.* (Exchequer and Audit Departments Act, 1866)

**Notes**

1. There exist three interrelated sources of demand for external audit: agency demand, information demand and insurance demand (Wallace, 1980).
2. It is acknowledged that this model does not capture the full complexities of the choice process (Francis and Wilson, 1988, p. 680). Noting that this economic theory of auditor choice is a normative theory we argue that, to explain actual auditor choices, the model will need to incorporate behavioural/social factors.
3. An auction is a market institution with an explicit set of rules determining resource allocation and prices on the basis of bids from the marketing participants (McAfee and McMillan, 1987, p. 701). There are two perspectives, depending on whether the auctioneer (or bid taker) is the seller/buyer (and hence bidders are buyer/sellers). Most usually, the auctioneer is the seller (or seller's representative); however, in industrial procurement (as in audit services) the auctioneer is the buyer. The term "tender" is reserved for this latter form of auction.
4. Milgrom (1989, p. 9) illustrated this as follows: "suppose there are two bidders, one who is known to have a personal reservation price, or valuation, of $101 and a second whose valuation is either $50 with profitability 4/5 or $75 with probability of 1/5. The first bidder is assumed not to know the valuation of the second, but he knows its distribution. If the first bidder bids $51, he will win $50 (his valuation minus his bid) at least 4/5 of the time, yielding an expected profit of at least $40. If he bids $62 or more, he can win no more than $39 (= $101-$62), so he will never make that choice. Since the first bidder never bids as much as $62, an optimising second bidder must win sometimes when his valuation is $75, and the allocation then is inefficient".
5. In certain specialized industries (e.g. banks) the firm's technical expertise in the area also acts as an initial filter in the selection of tenderers.
6. Estimates of the duration of alignments for UK listed companies range from 20 years (Beattie and Fearnley, 1994) to 50 years (Pong and Whittington, 1994).

7. Bid preparation costs can be considerable, with the costs of bidding for a UK local government contract estimated by a big six partner to be up to £250,000 (*Accountancy Age*, 28 April 1994).
8. To the extent that the provision of audit services and NAS are interdependent, the decision may not be risk-free.
9. Second tier firms were selected despite pressure from non-executive directors to appoint big six firms; pressure partly driven by personal contacts and partly (we suggest) driven by a self-interested desire for the additional protection of the big six name. In one case, for example, a second tier firm was described by a non-executive director as *"second-rate"*.

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