STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Company B

Background

1. [Company B] (the company) was a FTSE 250 business that delivered a range of [✂]. The company had over [✂] employees in approximately [✂] countries across the UK and Ireland, Europe, the Middle East, Asia, Africa and the Americas.

2. It was ranked at around [✂] in the FTSE index. It was listed on AIM in [✂] and the FTSE seven years later in [✂]. The company had revenue of £[✂] million and profit before tax of £[✂] million in FY2011.

3. The company's major shareholders were institutional investors. [✂]

4. KPMG had audited the company since the mid-2000s [✂] when it was appointed to replace a Mid-Tier firm [✂]. The audit fee for 2011 was £[✂]. KPMG audited the overseas subsidiaries as well as the Group, with approximately [✂] per cent of the audit fee earned overseas.

The Finance Director's view

5. The FD [✂] trained at PwC and moved into industry after qualifying in 1994. He worked at [✂] for seven years, [✂] for two years and [✂] for seven years. He joined the company in [✂] as Group Finance Director. The FD had worked with all the Big 4 auditors during his career but no Mid-Tier firms. The FD said: 'it has always been the Big 4, but I've always worked for big companies'.

Relationships

AEP

6. The FD mainly interacted with the AEP and less so with the senior audit team. The relationship was most intense at the end of an audit when the FD discussed any issues identified by the auditors.

7. Each subsidiary of the business was audited and had a separate 'clearance' meeting, where all issues were discussed with the AEP. The FD attended the majority of the clearance meetings. Issues would be debated and then there was then a final wrap-up meeting where the AEP and FD collated all the issues discussed.

8. The FD did not closely monitor the work of the audit team. The company's finance managers were closer to the auditors and called the FD if there were any issues that raised concerns. The FD could receive a lot of information if he wanted, but he had limited time and it was not his job to set the scope of the audit.

9. The FD wanted KPMG to audit all the subsidiaries. Sometimes in the case of an acquisition there was a period where another firm finished an audit already underway, but in the main he preferred to use just one audit firm.

Audit Committee

10. The FD met the ACC formally two times a year and also at monthly board meetings. The FD said the new ACC (appointed in [✄]) had been quite involved with the role, and interaction had 'gone up a step'. He saw her once a month at Board meetings.

11. The Audit Committee saw KPMG's pre-audit plan which detailed the areas KPMG wanted to review and then its final audit assessment. The FD provided a copy of the accounts and a copy of the internal control environment to the Audit Committee. He also provided details of other relevant ad hoc pieces of work, for example tax policy and treasury policy.

Shareholders

12. The FD had very little interaction with shareholders during the course of the year. There were two meetings with shareholders per year but the subject of the auditor had not come up. The FD's opinion was that shareholders saw a clean audit opinion and assumed that everything was fine. The choice of auditor had not been challenged or rejected at the AGM.

Resolution of audit issues

13. Any resolution of audit issues normally amounted to a discussion about differences of opinion. The discussions were to make sure that the accounting treatments used were within the rules and were pragmatic and sensible. The FD said that it often came down to materiality—looking at the items that were understated and overstated to see if they offset each other. If the aggregated issues were material then the accounts would be restated. This had not happened during his time at the company.

14. All issues were recorded and disclosed to the Audit Committee. However, only material issues were brought to the attention of the FD for discussion and only in the case of a very material issue or serious disagreement would the Audit Committee be involved. The ACC had the final decision.

15. The FD said that the company was a complex business with simple accounts (for example, there were no long-term contracts). Two issues the auditors had raised were the too rapid depreciation of assets (therefore understating profit) and the company making too many tax provisions. In the FD's and the auditor's opinion these issues were not material and not misleading to shareholders in any way. This was because there were items that cancelled these out.

Auditor selection

Annual reappointment

16. The FD made a recommendation whether to reappoint or switch auditors. Prospective firms would pitch to the FD, CEO and ACC. The annual review of the auditors was informal, tending to be a 'gut feel' on how much the company was paying and whether the auditors were doing a good job.

17. The FD wanted to switch auditor as he felt KPMG was a bit expensive. He would like to reduce the audit fee by 10 to 15 per cent [✄] (from an audit fee of £[✄]).The FD thought KPMG did a good job, but it was not as good in certain areas as he had previously experienced at other companies. The company had no internal audit

function and the FD wanted to make sure he was getting a very good level of service and the auditor was ‘really digging into the audit across the world’.

18. Specifically the FD felt KPMG could be doing better globally. Performance in the UK and a key Western European country [✄] had been good, but there were issues in [✄] with the auditor not being responsive enough or good enough. Generally the FD felt the audit was not giving the level of detail he would like in other parts of the world. He thought another firm could do better.

19. The FD also wanted the auditor to help the company grow overseas. For example, providing new contacts, introducing new customers and giving assistance—things KPMG was not doing. The FD wanted this as part of the service. For the FD it was about the people rather than the firm. If the audit went to tender, the FD would invite [✄] and [✄] to tender, but not [✄] as he did not think it had the international scope necessary.

Switching costs

20. The FD would always evaluate the positives and negatives of holding a tender process depending on the circumstances at that time, for example if the company had time. The biggest cost of running a tender and switching auditor was the time spent in the first year answering questions put to the company by the new auditor. The FD said the tender process itself was straightforward, but needed to be run efficiently so the decision could be announced and the new auditors could start in a timely way for the new reporting year. It was not the tender that took the time but getting the auditor up to scratch. This was a big factor at the company as the Group (ie head office) finance team was small. The FD considered it did take time for an audit firm to get to know the business and that it made sense not to switch auditor too frequently. Every business had specific accounting treatments with which the auditors needed to be familiar. An example at the company was [✄], (explained in more detail at paragraph 83).

Limitations on auditor choice

21. The company was not large but had operations around the world and therefore needed an auditor with an office in every country in which it operated or might operate. The FD had not looked but did not know if any Mid-Tier firms could provide this. The FD told us ‘maybe it’s a mindset but it’s got to be the Big 4 as they will have an office, and I can’t be 100 per cent sure that the Mid Tier will’. The FD thought it would look odd to have a Mid-Tier firm as auditor as the majority of FTSE listed companies used a Big 4 audit firm. People were important to the FD and he assumed the best people were in the Big 4. The FD did not know enough about firms outside the Big 4 and acknowledged there was a perception issue regarding Mid-Tier firms.

22. As an example of the advantage of the global network the Big 4 firms had, the FD explained that when the company bought another company out of liquidation in Malaysia it was able to use the PwC network to help facilitate this. PwC was the administrator, and the FD phoned the London partner to ask him to put forward the company as a reputable potential purchaser.

23. The FD thought that moving from the AIM to the FTSE might have played a part in the company’s switch from the previous auditor [✄] to KPMG, with the company needing a ‘bigger weight’ audit firm behind them. The FD also thought banks would expect to see a Big 4 firm undertaking the working capital report.

24. The FD said that Baker Tilly had approached the company for modelling work but not for audit. His knowledge outside the Big 4 was limited. He would consider smaller firms for smaller pieces of work.

Fees

25. The FD received a breakdown of the individual subsidiary audit fees which made up the total Group fee. It was almost impossible to benchmark against other listed companies given the variation in fees with regard to such companies. A former employee of BDO (who now worked for the company) had commented that the company's audit fee looked high, and subsequently the FD had negotiated a fee freeze. It was hard to determine the right fee and a lot was determined by the previous year's fee.

26. As stated in paragraph 25 the audit fee was frozen for the current year and had been frozen for the last couple of years. The FD thought this was a good result as the business had grown by approximately 10 per cent. The FD was open with the auditor about wanting to switch auditor due to the high audit fee.

27. In order to keep the fee flat the auditors had undertaken fewer substantive checks in China. The quality would still be high enough for KPMG to form its opinion but this was not the level of detail the FD would like. The company would therefore undertake further work itself in China to compensate. The FD noted this approach would still be cheaper than paying an increased fee to KPMG. The FD would rather have as low a fee as possible and have an internal audit function providing extra work which he could direct.

28. Generally, the audit fee was negotiated between the auditor and the FD and the Audit Committee signed off the agreed fee. If there was a severe disagreement about fees the Audit Committee would be involved, but the FD noted it would be embarrassing to go to the Audit Committee with a fee issue.

Quality

29. The most important aspects of quality for the FD were the auditors:

    (a) knowing what was important and picking up the big issues;

    (b) being pragmatic about the issues that mattered for the business in the long term; and

    (c) understanding what they were auditing.

30. The auditors rarely found issues which were not found internally. The company always discussed any material findings with the auditors about any issues which the company believed the auditors were unaware. For example, [✂]. Any such issues were not material and the auditors had improved in this area.

31. The FD gave the following as examples of value added services provided by the auditors: giving confidence to the FD that there was no fraud and that the internal controls were good. For example, a review of treasury functions was conducted by the auditors in 2011, and they also provided some due diligence (although the FD noted that any firm could do that). The FD used to receive management letters indicating where internal controls could be improved which had stopped. He had

asked for these to be provided again. The company had just been through audit partner rotation but the FD had not noticed any major changes.

Non-audit work

32. The FD said that the company tended to do most non-audit services themselves as external advisors were very expensive. All outsourced non-audit services were put to competitive tender and different firms were selected for each piece of work. No work was automatically given to KPMG. The FD highlighted that KPMG conducted due diligence for only one of five acquisitions last year. Deloitte were the current tax advisors for the company, which the FD said might change.

33. For Class 1 transactions (ie where an acquisition or disposal represents more than 25 per cent of the company's size), where many detailed reports had to be produced for shareholders under time pressure it would be sensible to use the auditor as they knew the business. Generally the FD said that 'They [the auditors] don't know the business like anyone in the business does'.

34. The FD thought that audit and due diligence were fairly similar but with due diligence the information received was limited depending on the company being bought. The auditor could obtain any information from the company. The FD thought due diligence quality varied enormously—a reason for moving from firm to firm trying to find someone who could do a good job. The quality still ultimately depended on the country and the people on the team.

The Audit Committee Chair's view

35. The ACC trained at Arthur Andersen and worked there from 1977 to 1982 focusing on small business audits. This included one year at Accenture working in consulting. The ACC had broad experience in both the private and public sectors. She had held positions in private equity, a newspaper business, Government, the NHS, the police and the rail and charity sectors. She had worked for two FTSE100 companies in senior roles and held one other NED position with a global pharma business. The ACC was recently appointed to the company's board in [✂]. During her career, the ACC had worked with EY, KPMG, PwC and several Mid-Tier firms.

Relationships

AEP

36. The ACC was relatively new to the position, and her appointment coincided with audit partner rotation at the company. There was an initial handover meeting with the old and new AEPs and with audit manager (who had experience of auditing the company). She was very happy with how KPMG conducted the handover process for both the AEPs and the ACC.

37. The ACC met the AEP on a quarterly basis. She also met the AEP and the audit manager formally in meetings at the start of the audit, before interim results were published and before the audit close meeting.

Management

38. Outside monthly Board meetings, the ACC communicated with the FD every six weeks either face to face, by telephone or by email. She met the CEO on a quarterly basis.

39. The ACC did not view the role of auditors as protecting shareholders from management. She saw the auditors' role as to ensure that the accounts gave a true and fair view of the company's trading position and balance sheet. In addition the auditors' view could help with the effectiveness of the company's internal controls. The FD had undertaken significant work improving the internal controls and the auditors had supported that work. The FD would direct the auditors to areas that he considered important—the auditors were used as the eyes and ears of the central team as well as the Board.

Shareholders

40. The ACC had no interaction with shareholders apart from the AGM. Interaction with the shareholders was mainly by management and the Chairman. The Chairman contacted the top ten shareholders once a year to see if they wanted to meet or had any questions.

Auditor selection

Annual reappointment

41. Since the ACC's appointment, KPMG's audit team, the scope of its work and the question of whether the audit should be tendered was formally reviewed in the Audit Committee. This was associated with the rotation of the audit partner rather than the arrival of a new ACC. The company wanted to check the audit coverage (ie how much was tested), how long the auditors took to do things and how much was asked of the company in terms of schedules. It also looked at how well the auditors got on with the company and how well they understood the business.

42. The ACC had asked for a list of all the staff who had worked on the company audit in the last three years as she wanted to check the mix of continuity and the refreshing of staff. She was happy with the auditors' resources and liked the balance of having an audit manager with experience of the business and a new AEP with a fresh pair of eyes.

Switching costs

43. The ACC was not planning to tender immediately but said that she quite liked to tender every three to four years, although this would not be undertaken lightly. Currently the company was happy with the work KPMG was doing as the audit team knew the business well and the new AEP had got to grips with it well too. Any decision to tender would depend on the merits of switching. Generally, the ACC thought tendering was not a process to be taken lightly as it was a 'hugely expensive exercise' for both the company and the audit firms. For the company, time was spent planning the tender brief and explaining the company to new auditors. The ACC confirmed that she could force a tender if she wished as this was in the terms of reference of the Audit Committee. However, this would not be something she would wish to do, she would aim to agree any decision to run a tender process with management and the audit committee.

Limitations on auditor choice

44. The ACC would only invite Big 4 firms to any tender. The main reason was the global coverage that these firms offered and their experience of acting for other global clients. The ACC would take 'a lot of persuading' to use a Mid-Tier firm. As an example, the ACC had worked a lot in the USA and China where the working culture was very different to the UK. It was important that local teams understood the culture in order to conduct an effective audit and to work successfully with local finance teams.

45. The ACC did not know, but guessed that Mid-Tier firms were represented by affiliates in other areas of the world. The problem with affiliates (based on the ACC's experience in PR rather than audit), was the difficulty of maintaining global standards and training. The ACC thought that Mid-Tier firms were not suitable given the company's size.

46. The ACC was not on the board at the time of the switch and was not aware of the reasons behind the switch from the previous auditor [✂]. She thought it might have been to do with the company's move from AIM to a full listing but also in part due to the company's geographical spread.

47. The ACC did not think the Big 4 differed much among themselves in terms of global reach or fees but she considered they did have different sector specialisms. As an example she noted PwC's large presence in the charity sector.

48. If running a tender process, the ACC would seek to limit the process to three out of the Big 4 firms so that she did not waste anyone's time. She would be guided by the FD and the Audit Committee as to who he wanted to include in any process.

Fees

49. The CEO and FD took the lead on fee negotiations, and the fee was discussed with the Audit Committee and then the Board before being put to shareholders for approval. The fee was split by location which was an advantage to the ACC as first it gave a good indication of where the auditor was devoting resources, and second it allowed the ACC to assess whether this matched with where she and the Audit Committee expected to see more or less resources. She always asked how the fee compared with the previous year and whether company management was happy with the level of the fee. The ACC wanted to check that fees had been discussed and not just accepted at face value. She would follow up any concerns if necessary.

50. There was no benchmarking of the audit fee apart from a comparison with the previous year's fee. Fee variation depended on the scope of the audit and differences in approach for particular locations. For example, some work had been scaled back as it was considered the businesses were more established than in previous years. With new business, the auditors undertook more work to ensure controls were replicated accurately throughout the Group.

51. The ACC thought fees were not an issue in auditor selection: fees would be a consideration in a tender process but were not likely to be the driving reason for the tender or the decisive factor in the outcome of a tender. She thought the current audit fee was not unreasonable but the culture at the company was to pay as little as possible on any external adviser fees.

Quality

52. The ACC used the auditor scoping document to assess the auditor's approach to the final audit process. She looked for broad based coverage from the audit and the areas of risk identified, and whether they coincided with her own views. For example, the ACC had asked the auditors to focus on two specific areas this year. These were both to do with recent acquisitions. She had asked them to ensure that the accounting procedures present in the rest of the group were now embedded in an acquisition made last year and also to review the working papers of EY who had audited a recent acquisition. There had been no resistance by the auditors to the extra emphasis requested by the ACC.

53. The ACC looked for both geographic coverage and coverage of the key financial areas in terms of financial risk (ie testing across geographies and testing key risk areas). She was interested in areas where there had been change. For example, if there were changes in personnel (perhaps new financial controllers in the business) she liked the auditor to check they were complying with Group standards.

54. The ACC had little visibility of what happened during the actual auditing process. The ACC wanted to understand what issues the auditors had found and what decisions the AEP wanted the Audit Committee to take if there were to be any adjustments to the accounts prepared by management. The ACC found it helpful that KPMG split its work out to inform the Audit Committee of changes to accounting standards and changes to the company's accounting policy. This helped the other Audit Committee members who were not qualified accountants. The ACC said she could tell if an audit manager or AEP was out of their depth or unsure about something.

55. The ACC would only take issue with aspects of audit service delivery if management raised it as an issue. These issues tended to be, for example, the audit taking too long, for example the auditors were always on the premises and asked too many questions, and therefore were not doing an effective job.

56. For the Audit Committee, the value added above the audit itself brought by the auditors was that they provided another line of input (in addition to management) on changes to accounting standards or changes to corporate governance. For the ACC it was not about improving financial services or financial systems—any value added here was for the benefit of the FD.

Non-audit work

57. The company tended to use other firms for non-audit work. This was partly due to company policy and partly as it allowed the company to keep an eye on other firms from time to time. Historically the company had not used the auditor for due diligence work. The ACC said that in the past, performing non-audit services could be an advantage in tenders but this was not the case now.

The former ACC's view

58. The former ACC was ACC at the company at the time of the appointment of KPMG. He trained as Chartered Accountant at Arthur Andersen and remained there for around 12 years. He then moved into industry and had been FD and CEO of a number of UK listed businesses. He was now the ACC at a FTSE 100 company and Chairman of the company. During his career he had experience of Arthur Andersen, Deloitte, KPMG, PwC, EY, Grant Thornton and a local firm acting in audit roles.

The role of ACCs

59. He had been ACC for the company at the same time as holding an executive role elsewhere. He said it was relatively easy to find the time to undertake the ACC role. The experience of being a NED at the same time as being an executive director was healthy and beneficial as it gave the benefit of understanding how different businesses were run. The time requirement for an ACC varied depending on the company and the risks: generally being an ACC and NED for a FTSE 100 business took approximately 25 days a year. The former ACC considered that for financial services businesses the role of ACC was likely to be a more significant time commitment as the ACC was required to meet different regulators.

60. In selecting his replacement, the former ACC had himself drawn up a short-list of three candidates, from people he knew, or knew of. The Board (both NEDs and Executives) had interviewed the candidates and made the selection. The ACC was ultimately held to account by the Chairman.

61. The former ACC had not discussed audit related matters with shareholders either during his time as ACC or as Chairman. Indeed, the company's CEO was the original founder and shareholders generally were more interested in speaking with him directly than with the Chairman. The former ACC noted that it was more common for the Chairmen of Remuneration Committees to meet shareholders than it was for ACCs.

The selection of KPMG

Background to the tender process

62. The former ACC explained the events that led to the [✂] tender process. He said that the previous auditor [✂] had done a fine job and it was not its performance specifically that had led the company to review the choice of auditor, rather the company was listed on AIM and had undertaken a significant acquisition of a company that was listed on the main market. This increased the company's size by 30 to 40 per cent and increased its international operations. At the same time the company itself was preparing for a main market listing.

63. The company's management preferred one firm to audit the whole group. The acquired business was audited by KPMG. The company therefore decided it was an appropriate time to tender the group audit. It decided to invite KPMG, [✂] the previous auditor, and two other Big 4 firms, [✂] to tender.

64. The former ACC did not think it was necessary to invite another 'second tier' firm to tender. He considered it to be a 'brave ACC or CFO of a FTSE100' to appoint an auditor outside of the Big 4, as he consider that these four firms were perceived as more capable by the market and that this perception was driven not just by Boards but also by investors. FTSE 250 businesses had less pressure to appoint a Big 4 auditor but most aspired to be a FTSE 100 company and so would adopt similar approaches to FTSE 100 companies when appointing advisors, including auditors.

65. The former ACC explained that he would always want the CFO to be comfortable with the choice of auditor (unless there were some unusual circumstances) as it was the CFO who had to work most closely with them monitored by the CEO and ACC.

66. The company had used KPMG to undertake the due diligence work on the acquisition. The former ACC was unclear whether there had been a prior relationship with one of the Big 4 firms in the tender [✂].

67. The other Big 4 firm [✂] withdrew early in the process as it was undertaking a large NHS project and considered itself to be conflicted as the company was a significant stakeholder in the project.

The process and selection criteria

68. The process involved giving all the firms the same access to senior management. Each firm was provided with some summary information on the company and was required to provide a written presentation in advance of presenting to the Board. The firms were given clear rules of engagement for the presentations (how many people could attend, a requirement that they brought the team who would do the work, how long the presentation could be, etc).

69. The whole Board made the assessment (the former ACC noted that the company's Board was small and this would not be a suitable approach for all companies). The firms were assessed on seven criteria:

    (a) business understanding (business, market, international growth plans);

    (b) people (depth of experience and capability, cultural fit);

    (c) quality of written presentation (explanation of methodology, tailored to needs of the business, commitment to the company);

    (d) approach to resolution of technical issues (process and consistency);

    (e) international coordination and consistency (quality operations in each area the company operated in, confidence in ability of UK team to coordinate);

    (f) proactivity in audit and non-audit areas (new ideas, expertise to support the company in non-audit areas); and

    (g) fee (competitive, commitment to reduce the fee).

70. These categories were scored out of eight by each member of the Board and the overall marks for each firm formed the basis of the decision. Each category held equal weight. The former ACC noted that in his experience fee was rarely a differentiating factor and would not be a deciding factor. The negotiation on fee was usually around agreeing to fix it for three years after a tender (subject to major scope changes, foreign exchange rate fluctuation or inflation).

71. In the company and the previous auditor's case there were some concerns with an overseas practice, [✂]. The company had not been particularly impressed with its work on the company's first major acquisition which was in this country.

72. The Audit Committee and ACC had to see that the process had been run on a fair, objective and independent basis. If this was the case then they would tend to allow the CFO, with the endorsement of the CEO, the final say on auditor selection. However, the Audit Committee would not allow the CFO to select the auditors solely on the basis of fee. In the company's case it was not necessary to allow anyone the final say as there had been a clear preference and group consensus following the Board's appraisal.

The Audit Engagement Partner's view

73. The AEP [✂] joined KPMG in 1986 and became a Partner in 1995. The AEP currently audited one other FTSE listed company [✂]. In the past he had audited five other UK-listed companies [✂].

74. He started working on the company's audit following KPMG's successful tender. He had recently rotated off.

Relationships

Management

75. The AEP had extensive contact with management. He was responsible for the Group audit consolidation and all UK-based activities (there were about six UK businesses). He would meet the management of those businesses twice a year and during the audit process.

76. At the Group/Plc level he met the FD, Group Financial Controller, Treasurer and Tax Manager once a quarter and much more frequently during the audit process. This would be as much as all day every day for a week during the audit completion process.

77. The AEP would meet with the CEO twice a year to discuss the feedback on the audit and the planning of the next audit.

78. There was a straight and open conversation with the FD about fees and what the business issues were. [✂]

Audit Committee

79. The current ACC [✂] had joined the board after the AEP rotated off the audit—the AEP had crossed over with her for only one Audit Committee meeting. The former ACC [✂] was now the company's Chairman. The AEP had met the former ACC twice a year outside of the Audit Committee meetings (of which there were two or three a year).

80. The AEP considered both the ACCs to be very thorough and keen to hear the auditors' views. [✂]

81. In general, the AEP said that it was difficult to assess an ACC's quality objectively. He said that what auditors were looking for was someone approachable, who understood the issues at a business and technical level, who had an awareness of the trends in corporate governance, had time, and was even minded between the management and auditors if a conflict arose (although this would be unusual).

Shareholders

82. The AEP attended the AGM but had no direct contact with shareholders.

Resolution of audit issues

83. The AEP explained that the company's subsidiaries were relatively straightforward to audit. It was only a specific depreciation that was a little unusual as it combined

straight-line and reducing balance depreciation methods. To ensure the AEP was comfortable with the treatment, KPMG modelled the depreciation under four or five different approaches. These all gave similar and not materially different results. The AEP estimated that he personally spent two to three days understanding this treatment during the first KPMG audit and thereafter it was a case of refreshing the understanding each year and checking that the facts had not changed.

84. The main difficultly in terms of the audit came from aggregating the accounts as different IT platforms fed into the central IT platform, resulting in some IT risk. There were also 10 to 12 overseas jurisdictions which had foreign currency accounting, and in addition there was IFRS deferred tax accounting, goodwill impairments and share based payments which made for a fairly complex Group audit. The Group used some reasonably, but not very, sophisticated treasury systems and treasury management processes. The AEP said that it was in this part of the audit that the majority of the 'clever thinking' was required, as opposed to the more routine elements of the audit process.

85. The AEP said that he had never found the clearance meetings stressful. For him personally the most stressful part of this client relationship was negotiating the fee. 'The findings were what the findings were' and given the amount of time he had spent getting to know the Group and planning the audit there should be no surprises. Some issues were always debated by the Audit Committee, but so far these had not been fundamental as management had taken on board the auditor's comments to the satisfaction of the AEP.

86. The AEP thought that there were no differences in the nature of his relationship with the FD and ACC. What really mattered was that the issues that needed to be discussed were given 'a good airing' and all points of view were heard properly taking on board the views of management and the auditors.

Auditor selection

The appointment of KPMG

87. The AEP said that he had been involved in the tender process. At the time he was aware that a non big 4 and a big 4 firm had been asked to tender. He was not aware of whether anyone else was invited to tender.

88. In [✂], the AEP was doing due diligence work and he was approached by the company to provide due diligence services on an acquisition target in the Netherlands. Following this work, the AEP kept in close touch with the company as he felt he had experience and knowledge that would be useful to them. He had regular meetings with the FD, meeting informally quarterly to discuss the industry, how acquisitions were bedding down, general business issues, the transition to IFRS, market practice etc. The AEP said that it was easy for him to obtain access to management—in this case he had worked for them but on other occasions he had been able to cold call management teams and arrange meetings so that he could not say whether having previously worked for them was essential in this case to obtaining access.

89. His recollection was that the company had launched a contested takeover bid for another company in [✂] which concluded in [✂] and at the time KPMG had spoken to management about various issues. Management had flagged their desire for advisers to provide (i) strength in depth (technical), (ii) knowledge of the industry and (iii) global reach. These were the areas where KPMG had focused its pitch.

90. During the tender process, KPMG spoke to the company to understand what it was looking for and held three or four meetings with management to understand what it wanted from the auditor. There were a number of overseas parts to the engagement, so KPMG spoke to local teams to understand what would be required in these locations and to build an estimate of the fee. Three partners and a director were involved in the pitch, and the preparation process lasted approximately six weeks.

91. Reputation of the company (and all potential clients) was important so that KPMG client acceptance procedures were met (ie ethical, reputable, robust business model). The AEP said that he felt KPMG 'could work with them [the company] very effectively, and therefore it would be a mutually beneficial arrangement'. The AEP said the company's reputation did not matter in terms of being able to say 'Oh we've got the [X] audit'. The factors that made the company attractive to the AEP were that it had rapid growth, good results and was doing interesting things. As an AEP, he was motivated by working with dynamic clients and found these more interesting than static clients.

92. The AEP assessed that the FD would be the one to recommend the appointment of the audit firm, the CEO would have the right to veto this and the ACC would need to be comfortable with any appointment. KPMG therefore set about influencing the FD, making sure the CEO could not object and that the ACC could be comfortable with KPMG's independence and technical competence.

93. KPMG perceived a possible weakness in the company's IT strategy as an audit risk and therefore included an IT Partner in the pitch team. KPMG also saw that the company wanted to expand into the Far East and so they offered contact with a KPMG Director with experience in China to bounce ideas off.

Annual reappointment

94. KPMG was aware that the company went through a process to review the auditor each year, although KPMG was not party to the details of that review. KPMG would be informed by the ACC that it was acceptable from an objectivity and independence point of view, but not much more.

95. The management team and KPMG would debrief the audit together, providing each other with feedback on the operational aspects of the audit: timetable, people etc.

96. KPMG had not been required to retender formally. Informally, each year it was made clear that the management team had the ability to put the audit out to tender if they wished and if a satisfactory fee was not agreed. The AEP felt this was a credible threat as in his time on the audit, while the company had never said 'X, Y, Z will do it for ten grand less', the company had switched providers of other professional services such as property, legal and merchant banking.

Fee

97. KPMG pitched for the audit at £[✄]. The company said that it had a preference to work with KPMG but that another bidder had offered a lower fee and so it wanted to lower KPMG's fee. KPMG agreed £[✄] of efficiency savings and reductions in the statutory accounts process (ie work that the company rather than KPMG would do).

98. On an annual basis, the AEP would check that the FD had the authority to negotiate fees, would agree them with the FD, only for the CEO to reduce them further. The ACC always agreed with the fee proposal. The AEP said that it was not a case of

whether the work could be done for the fee, in his mind the two discussions (ie amount of work to be done and the fee) were to an extent decoupled as the work had to be done irrespective of the fee. If something came up in the audit then it would need to be properly assessed and the fee discussion regarding any overruns would come later.

99. Agreeing the fee with the Audit Committee was ‘inevitably a straightforward process’ as the management team would have already discussed the fee with the ACC. The AEP said he had never been asked by the ACC at this company if the fee was high enough. He explained that he would never be in a position to answer ‘no’ as any issues on fee would have been discussed with both management and the Audit Committee prior to the fee proposal being presented to the Audit Committee.

100. The AEP said that there was a point at which a firm could not do the work if the fee was too low, and that on this client he felt he had come reasonably close to that point at times. He described the recovery rate on the company’s audit as ‘pretty poor’. The AEP measured the audit fee on the basis of fee per hour. He considered a low (‘awful’) recovery rate for this type of client would be £[✂] per hour and an acceptable rate would be £[✂] per hour. He said the issue was not whether another audit firm could do the work for less, but whether they would perceive that they could. He explained that the audit looked relatively straightforward from the outside but the complexities with the consolidation would add time for any auditor and this would not be apparent before really understanding the business.

Quality

101. There was not much choice over the scope of the company’s audit as most parts of the business were statutory entities and so had to be audited in their own right. The scoping document would be discussed with the ACC, FD, CEO and Financial Controller so that any issues could be understood before presenting it to the Audit Committee. It was an iterative process with input driven more by discussion with management than by discussion with the Audit Committee. By the time the document was presented to the Audit Committee it was usually approved as it had been through the iterative process and the AEP would have discussed the scope with the ACC in advance. In one instance, the ACC had asked the auditors to do more work in China (where statutory audit was not required) not less and the client paid for this.

102. The AEP said there had been no AIU or FRRP reviews of the company. He considered that quality could be assessed by:

(a) identifying all the issues in the plan and conducting a technically robust audit based on this;

(b) checking the disclosure and technical issues with KPMG’s panel of experts if required—quality was evidenced through being prepared for these issues as and when they came up. For example, the company had suffered a fire and made a major insurance claim that the insurance company repudiated. The AEP was able to use KPMG’s public company reporting experience to help assist the client in accounting for and reporting this correctly.

103. In terms of the overseas audit, the key territory was a Western European country. The AEP visited twice a year for the audit planning and clearance meetings. He reviewed working papers on complex areas. The AEP noted that he was responsible for the audit of half the group as most was in the UK.

104. The AEP said the added value that KPMG could provide was in terms of observations as to the quality of management across the business. He said that the auditors got information on the business that did not necessarily flow into the accounts, so they were in a position to give feedback views on systems, procedures and people.

105. When the AEPs five-year tenure was coming up for renewal, he spoke with the ACC about nine months before, and asked him how he wished to proceed. He proposed the following options:

(a) the AEP would introduce a partner to the ACC to see how they got on;

(b) he would introduce two or three partners for the ACC to select; or

(c) the ACC had worked with KPMG and knew the firm well, so he could propose someone within the firm.

106. The ACC was happy to meet the AEP's proposed candidate and was satisfied that he was a suitable candidate. The proposed partner then met the FD and CEO. The new partner was given an extensive briefing and spent half a day with the AEP and the audit manager going through the files, findings and issues. He then met the ACC to get his take on the issues and risks and then the FD and CEO.

107. The AEP explained what he saw as the benefits of a long-term relationship—that quality improved not in terms of the end product, which was always the same, but in terms of efficient process and the observations that he could make along the way. The AEP said it was not 'completely unfair' to categorize him as being 'at the top of his game' when he did his fifth audit of the company, although he said there were benefits to having a fresh look. He said he would never use the word 'cosy' to describe his relationship with the company.

108. In terms of benefits that came with experience of the company, he gave an example where the auditors were looking at the company's banking facility, which covered euros and sterling with a cap over both. KPMG realized that if the euro dropped to 1:1.12 then the cap would be breached and there would be a potential going concern issue to consider as part of the audit. KPMG was able to flag this to the company as part of its half-year review, following which the company switched its debt from euros to sterling and therefore did not breach the cap when the euro did fall to 1:1.12. The AEP said that this was a business issue that would have become an audit issue. KPMG was able to spot this because it was familiar with the business. This issue could be seen as one of audit quality or good advice. The AEP thought that it was good advice that could have led to an audit issue if not picked up.

Non-audit services

109. The AEP said that KPMG had provided some non-audit services when the company transferred from AIM to a full listing but other than that, in addition to audit work, KPMG were used primarily overseas for statutory returns work and tax compliance. In the UK, the AEP from time to time introduced the company to other KPMG partners to talk about other issues. However, that the company had a 'buy elsewhere' policy when it came to non-audit services, KPMG was generally not used.

110. The AEP said that another firm providing services such as tax advice made the audit more complex, compared with KPMG providing the advice. In 2010, the company had undergone a complex restructure which the AEP needed to be comfortable with for the audit. If it had been KPMG advising, the AEP could have sat down with the

team to understand what they had done. Instead he had to rely on a brief meeting with Deloitte and a review of the working papers, which made things more difficult practically.