STATUTORY AUDIT SERVICES MARKET INVESTIGATION

[Company E]

Background

1. [Company E] (the company) specialized in [✂]. It had retail operations in the UK and Republic of Ireland. The [✂] business operated in the UK. The company was in the FTSE 250 index. In 2012, the company had revenues of £[✂] million and profit after tax of £[✂] million.

2. The company was audited by a Big 4 firm ([✂]) following a switch from another Big 4 firm ([✂]) in 2009. In 2011 the external audit fee was £[✂]. The external auditor also provided internal audit services to the company. The largest shareholders were institutional investors: [✂].

The Finance Director's view

3. The FD [✂] trained with [✂], qualifying as a Chartered Accountant in [✂]. He moved shortly after qualifying to [✂] where he worked in consolidation accounting for two years. His next role was at [✂] for eight years, which included work in the USA and as the Financial Controller for the UK. After two years working at the [✂] he worked at [✂] for four years latterly as Director of Financial Control, Tax and Treasury. The FD joined the company as FD in [✂] 2011.

Relationships

Auditors

4. Most interaction with the audit team happened during the half-year and year-end reporting periods. The FD also had a quarterly catch-up with the AEP and had met the [✂] regional Chairman once or twice in the last year. The FD also had contact with the audit team in relation to the company's internal audit which [✂] the external auditor also performed.

5. The FD thought he was quite involved with the audit process and wanted to know what was going on. He wanted it to 'feel like we have been audited'. The company was in the middle of the audit and the FD had put his head round the door of an audit team meeting to see how it was progressing. He was quite active in terms of understanding what the audit team was looking at.

6. The FD was also very involved with the company's internal audit. He wanted to up the ante with the internal audit to improve the business. He was in the process of recruiting a new Head of Internal Audit to bring this service in-house over time. At the moment, the company effectively owned the internal audit function but the external auditor provided the resource for it.

Audit Committee

7. The FD had a good relationship with the ACC. One change the FD made when he joined the company was that he thought it should be his responsibility to present the accounts and judgement areas to the Audit Committee to give assurance that he was

happy. Previously the current auditor had done this—it now commented on the judgement areas and gave its review after the FD had presented to the Audit Committee.

8. The FD worked closely with the ACC to build up the internal audit function.

9. The ACC was held to account by the Chairman of the Board and also the shareholders. The ACC had a meeting with one shareholder regarding the appointment of the same firm to undertake internal and external audit work reporting into the FD.

Shareholders

10. The FD had met shareholders but there was no discussion of the audit.

Resolution of audit issues

The audit plan

11. The audit plan was prepared by the auditor and was reviewed in [✄ *month*] (in preparation for the year-end audit in [✄ *month*] three months later). Work on the company's controls was undertaken in [✄ *month*] at the same time as the audit plan was reviewed. The review went through the key risks, ranking them in order of importance. As well as general risks, the FD looked for risks that were specific to the company. The FD always challenged the auditor to see if enough work was planned to cover all risks. For example, the FD added extra work to the audit plan due to the change in Finance personnel during the year. The FD had added extra tax work to the audit plan as the Head of Tax had changed.

Audit issues

12. The FD asked the auditor to split the presentation accounting issues/adjustments into those deemed 'factual' and those which were 'judgemental'. The factual issues were taken as read and the company would always follow the auditors' view. There was more discussion around the judgment issues, but to date there had not been any differences of opinion. The FD always attempted to ensure there were no un-adjusted differences remaining prior to audit sign off at the Audit Committee.

13. The company was not a complex business from an auditing perspective and therefore there was very little opportunity for differences of opinion. This was also helped by IFRS accounting standards which were more rules based (compared with UK GAAP which was more judgement based).The only area for debate was over fair-value calculations, and there were clear examples provided in the standards which gave guidance. Rule-based standards made accounting more straightforward.

14. An example where significant judgement was required was where the company acting as guarantor for leases relating to another business [✄] which had fallen into administration. There were discussions between the FD and the Auditors about the provision needed against the risk/liability. The FD wanted to be prudent and the auditors agreed with this.

Auditor selection

Switching auditors

15. The FD was not at the company during the [✂] tender process. The FD had found tender documents from three Big 4 firms and three Mid-Tier firms [✂] He thought that [✂] the other Big 4 firm had also been invited.

16. A review of the Audit Committee minutes showed that the ACC had met with [✂] the incumbent Big 4 firm, [✂] another Big 4 firm and [✂] a Mid-Tier Firm. The Audit Committee had asked that the discussions with the candidates covered Internal Audit work, tax efficiency planning, Mergers and Acquisitions and international operations. In addition, the discussions on Internal Audit included an assessment of the company developing its own Internal Audit function or, as an intermediate step, a move towards a combined assurance model.

17. When questioned on the appointment of the current auditor ([✂]) at the AGM in [✂ *date*], the Chairman had explained that following best practice corporate governance guidelines the company had sought to rotate to alternative auditors to [✂] (the incumbent had been the company's Auditors for a number of years, [✂]) and, therefore, following a repitch programme, conducted by the company's Audit Committee, the Board had decided to recommend a different Big 4 firm ([✂]) be appointed the company's Auditors.

Annual reappointment

18. While the ultimate decision rested with the Board, via the ACC, consideration of the auditor was within the FD's remit and if there were issues with the auditor he would be the first person to be aware of them. He was also heavily involved in discussions of the internal audit.

19. There was no formal evaluation of the auditors' performance on an annual basis, but there were informal discussions at all levels of the business. The FD would ask the Finance Team how the audit team performed and whether they covered all the issues. The ACC would ask the FD how his team had interfaced with the auditors.

20. The FD received feedback from his team on the auditors' performance. Clear feedback was then given to the auditors, particularly in relation to certain individuals on the team. For example, the FD would look to whether irrelevant questions were being asked, context not given or an understanding of the business was lacking.

Switching costs and tender triggers

21. The FD said that 'continual frustration' would trigger a switch. For example, if a member of the audit team clearly did not know what they were doing and the auditors were not responding to the feedback and areas to improve given by the company. The FD and his Head of Group Reporting Accounting were both former auditors, and the Head of Tax was ex-profession, therefore they 'know what good looks like'. If the auditors were not up to scratch then they would be replaced.

22. In his experience, the FD had not switched auditor but he had been told it was a real upheaval. However, his understanding of the process at the company (which occurred before he assumed the role) was that it was not too difficult. The FD cited that there would be additional time spent in the first year of the audit and some upheaval getting the new team up to speed, but with capable individuals who were

quick on the uptake and a professional handover service from the outgoing auditor, the process should be smooth.

Awareness of other options

23. The FD did not think he was limited in terms of the audit firms who could perform the company's audit. It was not a complex business and therefore Mid-Tier firms and Big 4 firms were equally well placed to audit the company. The FD compared the company to some of his previous experience which had been more complex as it involved pensions accounting and insurance.

24. The FD thought it was reasonable to expect that a Mid-Tier firm, such as BDO or Grant Thornton, would provide the company with its best audit team given it was a FTSE 250 business and that this might not be the case with a Big 4 firm. The advantage of using a Big 4 Firm was it brought additional [✂] knowledge of the sector and training capability. For example; the company was looking to build up its internal technical capability and the bigger firms were able to provide resource to do this. The FD had not considered the reputation aspects of appointing a particular auditor and did not know whether his shareholders would have a preference for a Big 4 firm or not.

25. The FD had also made a comparison between Big 4 and Mid-Tier staff when interviewing potential candidates for roles at the company, particularly at manager level. Manager level was where the majority of work was done on an audit and was therefore a very important position. There was a marked difference in overall capability between candidates from each type of firm—when interviewing 'you are more likely to find a better candidate from the bigger firms'. The FD explained that by capability he meant both technical accounting skills as well as wider skills such as: the ability to interact with individuals, think out of the box, be challenging to others and themselves, think about the bigger picture of the business, commercial awareness and a mindset to not just tick a box. He thought that there was more likely to be a higher calibre individual in one of the Big 4 firms than in other firms.

26. The FD had relationships with other Big 4 firms through other work performed for the company. No firm had raised the subject of the audit and the FD thought that the other firms were content with the more profitable consultancy work. The FD did not think this would prevent these firms entering a tender for the audit, but it did mean they did not try to force a tender. The FD commented that he was renowned for turning down dinners and other events, as he wanted to be seen as being transparent in his selection of advisors.

Fee

27. The company was in the last year of a three-year fee agreement and had not commenced fee negotiations.

28. In the FD's experience the three things that an audit firm would base fee negotiations on were inflation, additional work (for example extra subsidiaries or new systems), and changes in accounting standards. From a company perspective, the FD looked to shorten the audit period as much as possible and see what the company could give the auditor in order to make the audit easier. For example, he made sure that the company had a file of reconciled balances with a balance sheet on day one of the audit.

29. The FD looked to counter fee increases by identifying efficiencies and being tough on inflation. For example, the auditors may request a four per cent inflationary fee rise

and the FD may counter this knowing the audit firm was (for example) only increasing salaries by 2 per cent.

30. Changes in the audit scope were fairly easy to deal with in negotiations. If a subsidiary was no longer audited then the associated fee would not be incurred. A year or so after the acquisition of [✂], the company integrated its ledger system. This required additional extended assurance work by the current auditors for which the company recognized and was happy to pay.

31. The FD thought audit firms were generally good at recognizing that it was their responsibility to figure out how to interpret changes in audit approach due to a change in standards and subsequently to challenge themselves to make these changes as efficiently as possible. If changes in accounting standards required extra audit work then the company had to pay for this to give the Audit Committee the assurance they required.

Quality

32. The FD always questioned his team to ask, ‘Do we feel as though we have been audited?’ If the team was not nervous about the questions the auditor might ask then the FD was worried. The FD wanted a healthy debate with the auditor. He judged an auditor by how much they debated issues and how robust they were.

33. The FD knew his business well and as the current auditor went through the issues he could get a sense of whether they had ‘had a good enough dig’. The FD wanted the auditor to find something he did not know. He was satisfied if the auditors described an issue he was conscious of but also demonstrated a very good understanding of them. He was unhappy if the auditors presented issues he knew about but which the auditors did appear to have fully understood in detail. He would see this as a waste of his and his team’s time.

34. Sector experience was important to the FD. The AEP was able to use experience gained from other clients in the [✂] same sector to identify potential issues such as [✂].

35. The FD’s biggest concern was the management representation letter. He thought there was a tendency to put very specific things in the letter which he thought was a bit of a ‘get-out clause’. The auditor needed to be comfortable with these things and not leave them to management. If the auditor was relying on management too much the audit process became circular. The FD was always robust on this, if there were non-standard items in the draft letter he asked the auditor to do more work until it was comfortable.

Non-audit services

36. During FY12 the external auditor provided internal audit services and a small amount of extended assurance services to the company. Internal audit services were provided to the company with largely the same team (including the same partner) as for the external audit.

The Audit Committee Chair’s view

37. The ACC was a CIMA qualified accountant having trained in industry initially with British Leyland and finishing with ITT. The ACC had extensive [✂] experience, holding FD roles with a number of companies [✂]. He had held a number of ACC

roles, the first of which was with [✂] in 2005. The ACC was also the Chairman of [✂] plc and held a number of NED roles at the [✂]. He joined the company's Board in [✂] 2011.

38. The ACC thought the company was unique as it had no direct competitors, was a profitable business and had been growing 'safely' with a good dividend. When the ACC assumed the role the company had started to face questions about its future. There were questions over the determination of a strategy to become a [✂] and its dividend policy. After a recent acquisition there had been pushback from shareholders on the use of the cash. The company chose to undertake a share buy-back scheme of up to £[✂] million.

Relationships

Auditors

39. The ACC had regular contact with the AEP. The ACC met the auditors four times during the audit cycle. The ACC also met the AEP in the week before Audit Committee meetings to understand what was going on before the meeting. He spoke to the AEP about once a month.

40. As part of his recruitment process, the ACC met with the auditor before his official appointment. He thought there had been some friction in the company's relationship with the auditors and the Chairman wanted an opinion on the auditor from the ACC-designate (at the time he was the preferred candidate for the role). The ACC was happy to meet the auditors but was only prepared to form an opinion once he had worked with them.

Management

41. The ACC had regular contact with management, more frequent than the monthly board meetings. He had contact with the Chairman once a week.

42. The ACC thought the role of the NED was becoming one of more engagement with the business and he was encouraged to ask questions, get involved with the business and visit stores. Management had been questioned over strategy (see paragraph 38) and the whole board was actively involved in determining the new strategy.

Shareholders

43. The ACC received a specific request to meet two investors ([✂] and [✂]). The investors had a strong view that the same firm should not provide the internal and external audit, as they saw it as a clear conflict of interest. These investors voted against the Audit Committee report at the last AGM. These investors were informed of the company's intention to move towards a greater internal resourcing of the internal Audit function, recruitment is underway and the investors have subsequently indicated their intentions to vote in favour at the next AGM.

44. With regard to the internal audit the ACC said he felt like it was in-house, and that he considered there to be a lot of logical crossover between the internal and external audit. He understood how it could be perceived as a conflict of interest, but said on a practical basis it worked.

Resolution of audit issues

The audit plan

45. At the beginning of the audit process the ACC met with the FD and the auditors to discuss the audit strategy and identify the main issues and the areas to concentrate on. The ACC thought overall responsibility for the audit plan was with the FD. He thought the auditors should get the plan '80 per cent there' with additional input from management. The ACC would be disappointed if he had to add more than a couple of items to the plan.

46. In terms of observing the auditor's work the ACC was aware of the programme of work and asked the auditor and FD to 'keep him aware by exception'.

The ACC's role

47. The ACC estimated he spent 20 days per year on company business, approximately 40 per cent of which was spent on the audit. His remuneration was fixed for the year. This would only increase if something exceptional occurred, such as an acquisition, which would substantially increase amount of time required.

48. The ACC spent one day preparing for each of the formal Audit Committee meetings. He estimated that draft audit papers were 100 pages long. His greatest incentive to complete the job diligently was that he was 'putting his reputation on the line'.

Auditor selection

Annual reappointment

49. The ACC said that he was fully involved in decisions about the auditor. In previous roles the ACC had been through three tender processes, and in each case he had been fundamentally involved in the decision to tender and the decision to appoint the auditor.

50. There was not a formal review of the auditor's performance. The ACC said that there was a continual process as there had been issues in the past. At the year-end Board meeting there was always an item on the agenda to cover auditor performance. The review was more of an 'open forum' than assessing the auditor against set criteria.

Switching costs and tender triggers

51. In his experience (at other companies) the ACC had faced two issues that triggered a tender: on one occasion there had been disagreements over accounting issues and dissatisfaction with performance. On two occasions the audit partner had rotated off the audit. The ACC thought that the choice of auditor was relationship-based and when the partner rotated off it was a good time to look at the whole process. The ACC thought that after about six years he would stop asking 'why would we change?' and start asking 'are we happy to stay?'

52. The ACC thought there would be very little monetary cost to holding a tender and that the tender process would cause minimal disruption to the business.

Awareness of other options

53. From the ACC's perspective there was a narrow choice of firms. It was taken for granted that the Big 4 firms and the Mid-Tier firms could perform an audit and that

the choice of auditor was relationship based. The ACC did not think there were any differences between the Big 4 firms, and that a company was essentially 'choosing your partner'.

54. Based on his experience, the ACC thought a Mid-Tier firm would be able to perform the company audit, although he only had experience of the Mid-Tier firms in the UK. However, the ACC thought there was pressure for a PLC to use a Big 4 firm and that the larger the company the greater the pressure was. It was very hard to move away from the Big 4 and that 'no one lost their job for appointing a top four'.

55. The ACC had accepted non-executive invitation forum invites from three of the Big 4 [✂]. No one had approached him for the company's audit. He thought that as the current auditor was relatively new, no other firms would expect a change.

Previous tender experience

56. The ACC had been through tender processes with other companies. At [✂] there was dissatisfaction with the performance of the incumbent auditor [✂]. The ACC thought he had a choice over who to appoint but was 'leant on' heavily by the owner to choose [✂] as it already had a relationship with [✂].

57. At the [✂] the audit partner from PwC rotated off the audit and when the replacement also left the audit there was a breakdown in the relationship with the lead partner. Deloitte were appointed after a formal tender.

58. At [✂] was the auditor for nine years, and while there was no dissatisfaction with it the ACC thought it was good governance to tender. PwC and BDO were both considered suitable to conduct the audit but PwC were chosen. The ACC thought that there was no reason why BDO could not have done the audit, but if it was close there was no reason to move away from the Big 4.

Fee

59. With regard to the audit fee, the ACC was a bit worried in the period after a tender in case fees were unsustainably low. He considered low fees not necessarily to be 'healthy; you should pay for what you are getting.' The ACC preferred to have the fee fixed as this gave certainty to the company. The ACC was not sure why three years was chosen as the length over which the fee was fixed. He thought this might be because companies planned over this length of time.

60. The ACC used benchmarking to assess whether the audit fee was fair. The ACC thought the company was a unique business but this did not hinder the effectiveness of benchmarking as there were similar companies in terms of size and complexity to which to compare the audit fee. Given the ACC's vast [✂] sector experience he also had contacts at other companies he could talk to about fees. The ACC added that he would not choose the auditor only on the basis of price.

Quality

61. When he was appointed, the ACC thought the audit process 'felt a bit predictable and safe' and management were not sure how dynamic the process was. The ACC said 'I know what I know and I don't know what I don't know'. To address the 'don't knows' the ACC wanted the auditors to have the capacity to look at any issues that would not come up in a regular audit cycle that were worrying anyone (ie that if there were worries management or the NEDs could ask the auditors to look at something

particular outside the audit specification). The ACC was adamant that he wanted the capacity for this but would not want to be charged extra for it.

62. The ACC thought the most important aspect of quality was that there were ‘no surprises’. The ACC looked for the quality of planning and preparation, leadership of the audit team, quality of the audit team itself and communication. The ACC took the audit process as a given in one of the Big 4 firms and that differentiation between them was in their execution and communication.

63. The ACC saw the auditors as ‘business partners’ and not just there to provide an audit. He wanted to access areas of expertise from non-core areas of the audit firm, for example to address tax, treasury and governance issues or to look at particular technical accounting points. Understanding the business was harder for the ACC as he was outside the normal day-to-day running of the business. The auditor spent time in the business and it was the auditors’ job to understand the business so the ACC saw them as a resource to be questioned about how things were going in the business.

64. The ACC thought that audit techniques had changed, particularly with the ability to interrogate information off-site. The ACC viewed this as a ‘double-edged sword’ as he preferred the auditors to be on-site ‘touching, feeling and smelling’ the business.

65. There had been no cases of restatements and the company audit had not been subject to any AIU or FRRP reviews during the ACC’s tenure.

Non-audit services

66. The current auditor did not provide other non-audit services to the Company. The company was always conscious of looking out for potential conflicts when using the auditor for non-audit services. The ACC highlighted that very little work was performed by other firms. The current auditor conducted the internal audit but the company was working to provide that internally. The company had external advisors for strategy related work.

The AEP’s view

67. The AEP [✂] trained at the audit firm qualifying in 1992 and became a partner in 2004. In the past he had audited listed businesses [✂] and an AIM listed business [✂]. Currently he audited four listed businesses in addition to the company [✂].

68. He had been involved in the company’s audit since the current auditor won the audit in FY [✂].

Relationships

Management

69. The management team had changed considerably since the current auditor won the audit. Prior to its appointment, the AEP knew the then FD and one of the group financial accountants (both had since moved on) from previous business relationships.

70. The AEP explained that PLC audits were different from private limited company audits as they involved interaction throughout the year. The company had three Audit Committee meetings to correspond to quarterly, half-year and full-year reporting. The

AEP attended all of the meetings and also separate planning and completion meetings with the finance team. In relation to the audit, the auditor also reviewed the interim management statement at half-year.

71. There tended to be two planning and two completion meetings to discuss the results of the announcements. Apart from these meetings the AEP tried to meet the CEO once a quarter for a one-on-one meeting.

Audit Committee

72. The ACC was the key focal point for communication with the Audit Committee. There were three Audit Committee meetings a year that the auditor attended. In addition, the AEP had two formal meetings a year with the ACC outside of the Audit Committee meetings and telephone calls as and when required. The AEP would not wait for an Audit Committee meeting to bring a matter to the ACC's attention. He saw the other Audit Committee members far less.

73. The Audit Committee saw the documents that the auditor prepared. These typically set out how an issue was discovered, how it arose and either how it was resolved or whether resolution was still necessary. Whilst this was high level the Audit Committee could question the AEP as much as it liked. The AEP made a call as to how much detail should be flagged to the Audit Committee—what he considered to be either material or interesting.

Shareholders

74. Some of the directors were shareholders, although none had significant shareholdings.

75. The AEP attended the AGM, but did no more than interact over coffee. He would be reluctant to engage with any one shareholder over audit matters as he saw his duty to be to the shareholders as a whole and not to any particular one.

Resolution of audit issues

The audit plan

76. The auditor prepared the work plan in detail and discussed it with management to establish the key audit risks and how it planned to approach them. This formed part of an Audit Strategy document which was agreed in draft with the FD before being presented to the Audit Committee for approval.

77. The AEP thought management saw a lot of the detail of the auditors' work. There were regular meetings during the audit between the audit team and the relevant level of the Company's team. The Audit Manger spoke to the Group Financial Controller on a daily basis during the audit—the approach was very interactive. The Financial Controller, FD and Group Financial Manger were the three key people at the company and they saw the 'warts and all' of the work to the extent that there were issues. If there were no issues then the auditor did not feedback in detail on the work undertaken.

78. The AEP thought that the new FD was very diligent and professional. [✄]

Audit issues

79. The company made a fairly major acquisition [✂]. The company did not have a track record of acquisitions and it had grown organically over the last [✂] years. The IFRS treatment of acquisitions was complex and [✂]. The valuation of intangibles could have been a significant area of complexity.

80. This was discussed at length with the Audit Committee who supported the use of an independent expert to value the intangibles. The company initially resisted as it did not want to incur the costs. The AEP persisted and explained the value in doing a review. He was fully supported by the Audit Committee and the review took place. [✂]

81. The AEP noted that the company was an inherently simple business. It was a [✂] business without complex contracts or complex customer deals, and apart from the acquisition, the audit involved reasonably straightforward accounting.

Auditor selection

Switching auditors

82. The AEP's understanding (he did not know the detail) was that the new CEO [✂] put out a number of contracts to tender during his first year with the company. The then FD was happy to run a process as the incumbent auditor had been appointed for over ten years. The process was held as a matter of good governance but it was initiated by the new CEO.

83. The tender process began immediately after the company's year-end so an auditor could be recommended at the AGM.

84. The current auditor received the invitation to tender in [✂] and the process was completed in approximately six weeks. Four firms were invited to prepare a proposal document and three were invited to present to the Company. The AEP thought that three Big 4 firms ([✂]) and a Mid Tier firm ([✂]) were invited to tender. The AEP said the process was a fairly standard PLC tender process.

85. Each firm had access to the company via three to four fixed meetings with management. The initial meeting was with the Group Financial Controller discussing the audit approach and issues from previous years. There was also a site visit which the FD and FC attended, where the current auditor could question [✂] managers about processes, systems and controls. The current auditor had a call with the ACC for an hour to discuss governance and there was a final meeting with the FD. The AEP thought he had as much access as he needed.

86. The process culminated in a presentation to four people: the ACC, CEO, FD and Group Financial Controller. The current auditor was told of the result the next day.

87. The current auditor went through an internal process checking risks and conflicts. It had not provided any services to the company for a long time, although in [✂] it had provided some tax advice to them but nothing that compromised independence.

88. The AEP had an existing relationship with the FD (see paragraph 69) and tried hard to see him as often as he could, typically once or twice a year for three years prior to the tender.

89. The AEP considered the decision to recommend the current auditor was a committee decision but said the FD drove the process, with the FC, ACC and CEO having input.

90. The feedback received was verbal and high level:
(a) the current auditor was competitive on fee (which was a benefit to the pitch);
(b) value for money was what the company was looking for; and
(c) the current auditor was proactive.

91. As examples of pro-activity, the AEP said that the current auditor had provided examples of innovative ways in which they could report to the company giving a view on systems and controls, how the company compared to its peers etc. It had successfully articulated how it would challenge management's thinking.

92. The AEP was not sure how important the fee was to the selection.

Annual reappointment

93. On an annual basis the Audit Committee formally reviewed the current auditor. It did not see the results of this—only the decision of whether to reappoint.

94. The current auditor and the company's finance team held a debrief for one to two hours. In the past this had not highlighted any serious issues but there were areas to improve around interaction and communication. As an example, the Audit Committee wanted the current auditor to do more work around the quarterly reports, [✂]. It was also agreed that management should report on this to the Audit Committee.

Fee

95. During the tender process each firm was given access to various people in the business who it could question, as well as access to management accounts and previous Audit Committee reports. The current auditor had experience of auditing similar businesses which helped estimate the number of hours of each grade of staff that would be required. It had an internal fee review panel who challenged the proposed fee to ensure it was at the right level. It could be challenged as being too high or too low depending on the circumstances.

96. The current auditor bid for the audit with a proposed fee of £[✂] (including £15,000 for the half year review). A fee slightly lower than initially proposed was eventually agreed upon after negotiations. The fee was agreed for three years (this was requested by the company in its invitation to tender). There was a significant acquisition in the first year of the current auditor's appointment that increased the fee by £[✂] (£[✂] in later years).

97. The AEP noted that he had seen fees agreed for four years, more often two to three years and never for five years. He thought that three years was a time horizon that people felt comfortable with.

98. The FD led the fee discussion and then consulted with the ACC and CEO to make sure they were happy with it. The AEP would never start work on an audit without having agreed the fee first. The company drove a hard bargain and wanted to understand what work would be done and how many hours it would take.

99. [✂] In the first year there were inevitably setup costs which affected the recovery rate. The AEP wanted to understand the business properly which meant the review

time was longer. He had 'more meetings with more people' and met staff from the operations side of the company as well as the finance team.

Quality

100. The AEP said that the current auditor brand was all about quality. First, the AEP would do whatever work was needed to sign or not sign the audit opinion. Second, he focused on communication, making sure the company knew how issues had been resolved and any issues there might be in the business.

101. There was an internal audit firm consultation process with a 'quality control reviewer', ie another experienced partner who was not client-facing with the company who would challenge the AEP on his conclusions.

102. The company had a business outside the UK [✂] but it was small and did not require a local statutory audit. The main running of this business was from the UK and therefore the audit work could be undertaken by the UK audit team.

103. The company had never pushed the AEP to reduce the scope of the work. The Audit Committee had asked the current auditor to reduce the level of materiality to a lower level than the current auditor required to conduct a statutory audit. The current auditor did not have much scope to do more work within the existing audit fee. Therefore this was negotiated with the Company, which was prepared to pay for the extra work.

104. There had been no issues with restatements during the current auditor's tenure. On appointment it had reclassified some prior year balances [✂] which it had been uncomfortable with. The AIU had undertaken an inspection on the first year of the current auditor's appointment and the results were positive. The audit had been selected for an internal quality review within the audit firm.

105. The AEP thought that the audit firm's audit methodology drove the work the work that was conducted for the audit of this Company. The AEP also noted that when he was making decisions based on this methodology, he was aware of the risk that he was personally liable (ie he could be sued) if decisions were incorrect or the work was not high quality.

106. The current auditor had already started thinking about partner rotation (the third audit was about to start). It wanted to introduce the company to another partner towards the end of the fourth year so there was a sufficient handover period. The new partner would not be involved in any decision-making. They would attend meetings to understand the business and get to know people at the company.

107. Over time, the quality of the opinion stayed the same but the quality of reporting and communication with the client improved. The AEP said that in his three years there had been a new ACC, new FD and new Audit Committee member so he was dealing with new people. The only risk to breaching independence standards would be if the AEP was there for more than five years but this could not happen.

Non-audit services

108. The current auditor had undertaken non-audit services for the company. All of this work was put to competitive tender.

109. The company engaged the current auditor to perform additional controls testing as part of the internal audit work. The current auditor performed work in the following

areas, which were allowed to be performed by the external auditor under FRC guidelines: extended assurance and internal audit support. Extended assurance related to an extension of the internal control testing done as part of the external audit, either with different sample sizes or different areas being tested. Internal audit support was assistance in the appraisal of the internal control systems and assisting in reviewing processes and controls in areas not required to be assessed in detail as part of the external audit.

110. FRC guidance stated that internal audit services can be performed by the external auditor where there is 'informed management' taking full responsibility for the internal audit plan and that the external auditors were not performing a management role and did not place significant reliance on their own work during the external audit. The overlap between staff members on external and internal audit work depended on experience and availability. Both services provided by the current auditor required knowledge of the company which made it efficient for the external auditors to carry out the work.

111. The AEP had visibility over the work being provided by the current auditor as he had to give permission for it to be performed. There was no pricing benefit for the auditor in providing those services from an audit point of view. It did not reduce the audit work that the auditor was required to do.