STATUTORY AUDIT SERVICES MARKET INVESTIGATION

[Company C]

Background

1. [Company C] (the company) was a multinational [✂] insurance group [✂].

2. It was ranked at around [✂] in the FTSE 100 index. In 2011, the company received insurance premium of £[✂] had profit after tax of £[✂].

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

4. The company had switched auditor from one Big 4 firm [✂] to another [✂] within the last five years following a formal tender process. The previous auditor had previously audited the company for many years. The audit fee for 2010 was £[✂] million, and the current auditor also earned non-audit fees of £[✂] million. The current auditor audited the overseas subsidiaries as well as the Group.

The CFO's view

5. The CFO [✂] trained at a Big 4 firm and left a couple of years after qualifying. He had significant industry experience before joining the company.

6. During his career the CFO had worked with auditors from three of the Big 4 firms [✂] and [✂]. He had no direct experience of smaller firms.

Relationships

Auditors

7. The CFO had regular monthly meetings with the Senior Partner and AEP. At each reporting point there would be a number of additional meetings to discuss the results. There were pre-meetings before the Audit Committee meetings and the Audit Committee meetings themselves. The interaction was most intense at year-end, less so at the half-year and even less at the quarterly reporting, as the auditors did not officially report on the quarterly results.

8. The CFO said that he had pretty good visibility of what the auditors were doing, the geographies they were looking at and the matters that concerned them. There were monthly updates with the auditors. The CFO updated the auditors on the company performance, whether the company was considering any significant staff appointments and/or departures. The current auditor [✂] updated the CFO on the progress of the audit, matters arising etc.

9. The CFO said that the annual audit plan was nothing dramatic, ie it did not change significantly from year to year. Measurement of insurance liabilities was a prime area of focus for auditors.

10. The CFO expressed a preference for one audit firm conducting audits of all subsidiaries. He said the benefits of this were that it was easier to manage, to coordinate and to control. His only concern would be if the audit firm was not able to provide adequate competency in a particular territory. This was not an issue for the

company. He described joint audits as twice the coverage but half the value and considered the idea of better assurance was an illusion, as it was easy for issues to slip between the gaps in the firms. This view was based on his experience as an auditor on a joint audit rather than as a CFO purchasing a joint audit.

Audit committee

11. The CFO saw the ACC [✄] at each Board meeting, in advance of each Audit Committee meeting (to talk through the matters that would be discussed) and at each Audit Committee meeting. In addition, he saw him on an as-and-when basis if there was something he needed to bring to the ACC's attention, needed his advice on, or needed his agreement (for example non-audit service provision by the current auditor, see paragraph 43).

12. The CFO said that the ACC would not have as much awareness of the audit process as he did, but this was to be expected. The Audit Committee saw the high level plan and the broad themes and expected to be updated on progress. The Audit Committee commissioned the annual audit effectiveness review and agreed big ticket items but they did not need to be made aware of the general matters within this process.

Shareholders

13. The CFO had not had any discussions with shareholders about the audit, audit fee or provision of non-audit services by the auditors. Credit rating agencies had never mentioned the choice of auditor.

14. The CFO said that the lack of shareholder interest in audit fees reflected the company's appointment of recognized auditors for a commoditized service. He noted that one of the company's peers (who was performing significantly better than the rest of the industry in the UK) were audited by a top firm but had a very small audit fee and that an analyst had picked up on this in his/her reports, as a possible indicator of low quality.

Resolution of audit issues

15. The CFO said there had been no serious disagreements over accounting treatment with the audit firm. He said that the absence of such disagreements did not mean that the auditor was not providing rigour and direction.

16. The CFO provided the following as examples of where there had been discussions about accounting treatment.

    (a) [✄]

    (b) A bigger issue arose with the previous auditors [✄] over the valuation of a [✄] subsidiary. The Audit Committee had to engage in detail outside of Audit Committee meetings—they attended meetings with management and the auditors where this issue was debated. [✄].

    (c) [✄]

    (d) The former auditors challenged the company's application of an accounting standard. The company undertook additional work which was reviewed by the

former auditors as part of the audit process. The former auditors concluded that no adjustment was required. [✂]

(e) [✂]

(f) There was a tax change in the treatment of a subsidiary which was very technical. Bespoke sessions were held with the Audit Committee, management and the current audit firm to ensure all three sides understood and agreed the accounting treatment.

17. The CFO noted that the AEP was highly regarded by the Audit Committee for his judgement and fairness. His technical skill was taken as a given. He was viewed as having a great deal of knowledge and experience as such the Audit Committee would consider seriously anything he disapproved of.

18. The CFO had heard of instances where the auditor and management aligned against the Audit Committee but considered this to be rare and had never experienced this personally.

Auditor selection

The appointment of the current auditor

19. [✂]. The CFO explained that there had been occasions where the company had discussed a matter with the previous auditor, thought it was resolved, and then the previous audit firm’s head office would come back with a different view. This had been frustrating and time consuming, but was only one of a number of reasons for seeking a change.

20. [✂] The company had undergone a period of substantial change and challenges. It had had a long relationship with its previous auditor. It was the company’s policy to periodically review all major contracts, and the decision to put the audit up for tender followed an extensive review process.

21. The company ran a formal tender process, inviting the Big 4 firms only. The CFO could not remember if the company had considered the Mid-Tier firms—he thought not. He explained that they (the Mid-Tier firms) would not have the international scope or specialism the company required and so the company probably did not invite them to tender.

22. The Big 4 firms submitted a written proposal and presented to a selection committee comprising (approximately nine people) the ACC, CEO, CFO, Corporate Finance Director and the senior management in each of the directly affected teams. The selection committee selected two firms to make a final presentation to the Audit Committee.

23. The selection committee conducted a thorough evaluation of many different aspects of the proposed bidders. Each firm was given a rating on the key selection criteria and an overall rating. Each member of the group audit engagement team and auditors by region were also rated. The selection criteria centred on:

(a) The firm. Aspects of the firm included global coverage, insurance expertise, independence and firm policies in relation to ethical standards, provision of high quality teams and effective policy on managing technical queries.

(b) Auditing approach. Sensible approach to materiality and good, but not excessive, coverage of regional operations for Group audit. Effective on-site auditing.

(c) Audit time and fees. Reasonable cost (but not necessarily the cheapest), effective and intelligent budget process, appreciation that fees changed according to Group size and current key risks.

(d) Leadership from global engagement partner and key regional partners.

(e) Behaviours and attributes. Building relationships, working effectively together, proactive approach, commercial focus and timely delivery.

24. The results of this review were presented to the Audit Committee, with a summary and a view of the differentiating factors. A review of the assignments conducted for the company by the firms over the past two years was also included. Two Big 4 firms [✂] were selected to present to the Audit Committee. Both were recognized as having strong engagement teams. One [✂] was highlighted as having a distinct, commercial audit approach and a good cultural fit with the company. The other [✂] was highlighted as being particularly strong in a key jurisdiction for the company. The Audit Committee used the same criteria as the selection committee in assessing the two firms. It also looked at factors that would differentiate the firms under two areas:

(a) ability to help the company deliver its core objectives over the next three to five years (including: achieving control environment targets, M&A support, geographical footprint, access to market data and valuable insight, solving legacy issues, implementing Solvency II and IFRS phase II to suit the businesses needs and enhancing the capability of the company's people); and

(b) delivering a step change in audit service (including: provision of valuable and tailored support to the NEDs, senior people on site during the audit, coordinated global approach to planning, benchmarking the company against peers, project management to meet deadlines, regular updates, and regulatory and IT support and advice).

Annual reappointment

25. There was an annual appraisal of the auditor's effectiveness through a formal questionnaire completed by members of the Audit Committee, the Chief Auditor, General Counsel and regional senior management.

26. There were six areas of review:

(a) independence and objectivity;

(b) financial stability and risk profile of the firm;

(c) audit strategy;

(d) communication of adverse or unexpected findings;

(e) finalization of the audit; and

(f) concluding matters.

27. The CFO said reappointment of the auditors was a given unless something had happened.

28. In its Group Audit Protocol document the company stated, '[the company] will formally consider the appointment of its auditors every three years in accordance with procedures determined from time to time, which may or may not include an external tendering process'.

Switching costs and trigger points

29. The largest costs of switching were time and disruption. The selection process itself was somewhat onerous and time consuming but the real issue was educating the new audit team. The company was never very far away from issuing results to the market as it reported quarterly. Therefore it was a logistical exercise in appointing the auditors in time to conduct the audit: it required D-day style planning.

30. The CFO was happy with the current auditor's performance and had no plans to tender its audit services [✄]. He noted the AEP was approaching the end of his five-year term.

Awareness of other options

31. The CFO had not received unsolicited bids for the audit but the Big 4 firms regularly came to market their consulting services and they all wanted to have a relationship with the company.

32. There had been no approaches for any work from the Mid-Tier firms. The CFO said that he did not think that he had ever been approached by anyone from the Mid Tier. He was not entirely sure which firms made up the Mid Tier.

33. The CFO said if there was absolutely no choice he probably could go to a Mid-Tier firm and find a way to make it work. He was concerned that currently it would mean using Mid-Tier 'partner' firms in different territories and said this was too hard and he did not need this added difficulty.

34. Audit was a commoditized service; the company could instruct most of the Big 4 (some were perceived as stronger than others, given the company's specific requirements, [✄]). The CFO considered that there were too few audit firms. The PwC merger had reduced options in the market. If there were more competitors the CFO felt that there would be less risk in the system, more choice and marginally better prices.

Fees

35. The fees were fixed at the time of the tender for three years, and were subsequently renegotiated for another three years at a fixed level. The Group Financial Controller initially led on the fee negotiation with the CFO speaking to the AEP to reach final agreement. The Audit Committee had formally to approve fees.

36. Pressure on fees was increasing. The CFO said that previously the audit fee was one item that companies tended not to be under pressure to reduce, but as economic conditions had become tighter the audit fee was also under scrutiny.

37. The company had never threatened to retender in order to reduce fees. The CFO said that companies did benchmark although the company had not done this for some time and that such a process was never conclusive. When it came to agreeing the fees, the company stressed to the auditors that they should have become more efficient over time.

Quality

38. The CFO thought that quality was key to an audit and that it was the overwhelming requirement. It was important that the auditor could do a good job, and if they could, only then would he ask how much it would cost. The CFO set out his views on what was important to quality in the following order:

    (a) Could they provide a high quality service?

    (b) Could they do a good job?

    (c) Have they got the expertise on the ground?

    (d) Could he work with them?

    (e) Do they have the technical capability?

    (f) Are they in the right (geographical) places?

39. The CFO said the company brought issues to the auditor's attention not infrequently. He provided the following examples:

    (a) In the past there had been fundamental issues with the control environment resulting from the multiple systems with manual interfaces. The auditor raised these issues as minor weaknesses in its report on controls, but they turned out to be much more significant. [✂]

    (b) There was a numerical error in a complex calculation which neither the company nor the auditor spotted during the year. The CFO did not blame the auditor for missing this, the issue was not material and did not require a restatement of the numbers.

40. The CFO thought that identical companies A and B could each report in different ways and say and believe they had done the right thing. The value from an audit was having an audit. In particular, the value in an audit was not in the auditor finding points or arguing with management but that an audit kept people on the straight and narrow and was absolutely indispensible to the integrity of the published accounts, given the temptations and pressures to produce accounts that presented a company in the most favourable light.

41. The auditors made observations on the business each year which the CFO had not been aware of, for example control points [✂], but there was never anything dramatic. The CFO observed that auditors had tried to position themselves as 'business partners' which he did not think had any merit. [✂]

42. The CFO said that there was value in the auditors being able to inform the company as to how its accounting treatment compared to the market's approach. Awareness of what is going on at competitors was important.

Non-audit services

43. Provision of non-audit services by the auditor at the company was signed off with the following thresholds: under £100,000 by the Group Financial Controller, under £150,000 by the CFO, over £250,000 by the ACC.

44. The company was about to engage its current auditor to undertake a very large piece of consulting work in a key jurisdiction for the company's business in [✂], of the order of £[✂] million over two years. The ACC would need to be comfortable with this before agreeing to it. A tender process was held and the selection was between the current auditor and another large provider [✂]. The company considered that its current audit firm [✂] was best placed to undertake the work.

The Audit Committee Chairman's view

45. The ACC [✂] was appointed to the company board in [✂ *date*]. [✂]. He qualified as a chartered accountant in [✂ *date*] [✂]. He worked as an auditor for a Big 4 firm for [✂] before moving into industry.

46. He had held a number of senior finance roles in industry; the position of [✂].

47. Over his career the ACC had worked as an auditor with the company's current auditors and with auditors from all of the other Big 4 firms, a Mid Tier firm [✂] and a number of local firms.

Relationships

Auditors

48. The ACC met the auditors at the five Audit Committee meetings during the year. He also had two private meetings with the auditors in the previous year. When required, the ACC and AEP would talk outside meetings.

49. The ACC said that while the auditors presented and discussed the audit plan at Audit Committee meetings, this was only part of his relationship with them. The plan was presented against the backdrop of regular interaction and very open meetings. The audit partners were invited to discuss risks and express opinions on internal audit and other matters raised at the Audit Committee meetings.

50. The audit plan was presented based on the key risks, but nothing came as a surprise to the ACC, as risks were considered at each Audit Committee meeting throughout the year and any new risk areas would have arisen (and been discussed) long before the plan was presented to the Audit Committee. The ACC could not think of an area of risk that had been raised which was a surprise, due to the continual dialogue between the Audit Committee, management and the auditor. Equally the ACC could not think of an example where the Audit Committee had raised an issue at an Audit Committee meeting which had surprised the auditors.

Management

51. When the ACC joined the company there was no evidence of a working relationship between management and the Audit Committee. The ACC rewrote the agenda and role specification for the Audit Committee, with the full support of the Chairman and CEO. The CEO wanted the Audit Committee to set the standards for control, and this now happened, with the aim being to achieve a very open but well-managed relationship. The existing CFO fitted in well when he joined. [✂].

52. The ACC's principal interactions were with the CFO, the Head of Internal Audit and the Head of Risk. Once a year, the ACC spoke to regional CEOs and regional Heads of Audit about plans for risk management and internal audit. A large number of

management attended Audit Committee meetings in their entirety: the CEO, CFO, and other relevant members of senior management [✂].

53. The ACC thought the company needed a good enough CFO to be able to have open and professional Audit Committee meetings, otherwise the Audit Committee could not function well. Efficient running of the Audit Committee required the full engagement of the CFO. Outside of the Audit Committee the ACC would speak to the CFO seven to nine times a year.

54. The ACC was not sure how much time he spent in a year on the company's audit but felt he was proactive in the role. His remuneration was not linked to the amount of time he in fact needed. He thought that the role of ACC was not accepted thinking about remuneration. The ACC said he typically spent two or three hours reading before an Audit Committee meeting. He would also speak with the CFO and head of audit. He received around 300 pages of which the internal audit report (of around 100 pages) was the largest document. He said he might spend an hour reading that document.

Shareholders

55. The ACC had little contact with shareholders. Occasionally a shareholder requested a meeting. Very few institutional shareholders requested a meeting with either the ACC or Chairman. The ACC had met with [✂] twice, although these meetings were not specifically to inquire into audit issues.

56. The ACC saw his role was to see that the company was well run and controlled. He was there to represent shareholders and other stakeholders.

Resolution of audit issues

57. The ACC said the relationship between management and the previous auditor [✂] had been stilted and that there had been occasions when the previous auditor sought to use the ACC as a possible ally. In this instance, the previous auditor had got it wrong and the ACC, who had been well briefed, was able to point out why.

Auditor selection

The appointment of the current auditor [✂]

58. The company had been through an enormous transformation in recent years [✂]. During this period the company changed all of its advisors, but it was not thought sensible to change auditors at this time as there was so much going on in the group. Once this was over, given the slightly difficult relationship with the previous auditor [✂] such that a tender was inevitable. However, the ACC thought the company would have run a tender process in any event (as he believed it was healthy to review all professional relationships on a regular basis and to ensure proper competition for key services).

59. The ACC's role was ultimately to recommend the preferred audit firm. During the process he attended about twenty meetings with the bidding firms. He was available to all parties at any stage of the process.

60. The main selection criteria used were: did the firm have the right industry skills and the quality of the team across the group [✂]. The company assessed the people that the firms were proposing would work on the audit both as to quality and their ability to

understand and relate to the business. The ACC said that in the end from his point of view the firms all met the basic criteria for independence, what he wanted to see was whether they would be strong minded enough to match the company's own strong management team.

61. When it came to the final choice it was neck and neck between two Big 4 firms [✀], and the ACC would have been happy with either. The ACC felt one of these [✀] at the time had stronger experience in financial services than the current auditor, but the current auditor had demonstrated key skills and brought a bit more to the party. The current auditor's AEP had more big company experience and was supported by someone with extensive financial experience.

62. The ACC said that of the remaining Big 4 firms [✀] was strong in certain areas but did not quite have the geographic spread of the final two firms that were considered [✀]. [✀]. He said the previous auditor's AEP at the time of the tender was satisfactory. [✀] The ACC said he did not want to knock the previous auditor, the tender was closely fought between two very fine firms.

Annual re-appointment

63. The auditors' performance was reviewed formally every year (the annual review is described above in paragraph 26). The results of the questionnaire were presented to the Audit Committee which debated them. There were also informal discussions between the ACC and the CEO and CFO from time to time, to see how the relationship with the auditors was going.

Tender triggers

64. The ACC cited a breakdown in the relationship as one potential reason to tender. He also mentioned 'time'—that at some stage the company had to find out what was available and this could only be done properly through a tender. The ACC thought it was healthy for companies to go out to tender but did not agree with a policy of forcing a tender every seven to eight years.

Awareness of other options

65. The terms of reference enabled the ACC to insist on a tender, but he currently had no plans to tender as there was a good working relationship with the auditors and he was very satisfied. He foresaw a serious discussion regarding tendering the audit in the next two to three years.

66. The ACC thought that no Mid-Tier firm would have wanted to tender when the current auditors were appointed and did not think this had changed. This was because he considered they lacked depth in expertise and skills required for the company's audit. The ACC did not believe that Mid-Tier firms had the geographical spread or the expertise in [✀] insurance to be able to perform the company's audit. The Big 4 firms had good actuarial functions which made them attractive to the company. The ACC felt all of the Big 4 firms were able to compete for the company's audit work.

67. The ACC said if the company were to use a non-Big 4 firm it would need to work hard on its shareholders as they would be entitled to question that choice in terms of geographic spread and expertise. He thought shareholders and bondholders took comfort in the fact the company used a Big 4 audit firm.

Fees

68. The ACC was not involved in fee negotiations but the Audit Committee did have the final say. The ACC mainly wanted to ensure the fee was appropriate, ie that it enabled the auditor to deliver the service the company required.

69. At the time of the tender, the first year audit fee and the conditions for fee movements in the second and third year were agreed. This was at the request of the company in the tender invitation. The company did not want to be in a weak negotiating position after the first year, but agreeing the fee for a longer period, for example five years, felt too long to the ACC. He did not want to suggest that the current auditor had a mandate for five years.

70. The fee was not renegotiated after the tender which was a surprise to the bidders. This was consistent with the company's policy not to be unreasonable on fees. The most important thing was to obtain the right service. The company took the view that it would accept the fee but would ensure it obtained value. The ACC said that he did not negotiate to the last pound, rather he wanted to ensure that the current auditor was able to deliver the service he expected.

71. The fee in the tender had been broken down so the Audit Committee understood the hourly rate for each class of auditor involved from partner to junior accountant. The fee had not moved significantly, but the ACC saw no reason why it should have changed significantly. He noted that the Group had made acquisitions and the fee increased to reflect this.

Quality

72. In assessing quality, the ACC said that the Audit Committee heard the auditors present twice a year and he reviewed the management letter. The Audit Committee also received the internal audit report every quarter, which detailed (if relevant) how internal control issues that had been raised by the auditors were being addressed.

73. The ACC's view was that the auditor was part of the system of 'checks and balances' rather than being the unique system. The ACC could not know if the auditor was doing a poor job unless management raised an issue or something came to light after the event.

74. The ACC received approximately 300 pages of documents before Audit Committee meetings. [✂]. In addition, there were detailed reports on the key risks and the CFO's quarterly report.

75. The ACC gave an example of [✂].Given this, the ACC explained that there was a review which included asking the external auditor why they had not identified the problem. The ACC said that in his view no one could have forecast this but there were many questions raised afterwards.

76. The company also had a significant internal audit department of approximately [✂] people. The internal auditors examined at a lower level of materiality than the external auditors. The internal auditors looked at the entirety of the business, not just the financial results.

77. Members of the Audit Committee had attended audit committee meetings of most of the company's subsidiaries, and received the minutes of those meetings.

Non-audit services

78. The ACC's policy on non-audit services was to go where they were best provided, subject to any potential conflicts. The company had a protocol document that set out its policies regarding where the company was prepared to use the auditor for non-audit services and where it was not. The ACC said that not everything could be tendered as some things, particularly on acquisitions, were restricted by time.

The AEP's view

79. The AEP [✄] trained with the audit firm [✄]. He was also the lead partner on two other FTSE audits [✄] and had audited 14 FTSE 100 clients over his career as a partner.

80. The Supporting Audit Partner's [✄] only current FTSE audit was the company's audit. Prior to this he worked on the insurance operation of a UK bank [✄]. The Supporting Audit Partner also trained with the audit firm [✄].

81. The current auditor audited virtually all the company subsidiaries, certainly all the principal subsidiaries. When it took on the audit there were some subsidiaries that did not immediately transfer to the current auditor, due to regulatory reasons in particular territories.

Relationships

Management

82. The AEP had interacted with management at various levels over the last five years. He always met with the Group CEO at the planning, half-year and final audit close meetings. He met with the CFO at least once a month and more frequently during periods when there was a transaction or during the audit process. The AEP or his supporting partners also met regional and subsidiary CEOs regularly and with the finance teams during the planning, audit work and reporting phases of the audit cycle.

83. Interaction was most intense during the half-year and year-end reporting and when there were key transactions. The audit firm made use of the company's business reviews as an opportunity to connect with CEOs and divisional FDs to ensure that on a regular (ie approximately quarterly) basis, it was up to speed with what was happening in the business.

84. Key transactions were important as the auditor needed to be aware of potentially significant events that might affect the audit either in terms of reporting or the audit timetable.

85. Different layers of management saw different levels of the auditor's work. The finance teams, from CFO down saw the auditor's status reports, issues tracking etc. The CEO was involved at the audit close meeting to discuss the results of the audit.

Audit Committee

86. The AEP always had a call with the ACC before Audit Committee meetings to discuss what was on the agenda and how he saw the meeting progressing, what he would like particular emphasis on etc. He had a private meeting (ie without

management present) with the Audit Committee twice a year, during the half-year and full-year reporting periods.

87. The AEP thought the Audit Committee should have a very good understanding of the key judgements made and of the audit process. The planning document provided sufficient detail and had to be formally approved. The current auditor regularly talked to all Audit Committee members to ensure that the auditor's reports contained enough evidence and explanation of the conclusions.

88. The AEP noted that the ACC asked each individual Audit Committee member to comment on the areas that the current auditor and management had flagged and they challenged and asked questions about why things were or were not on the list of specific audit issues.

Shareholders

89. The AEP attended the AGM. In his tenure he had received no direct enquires either at the AGM or separately from shareholders. The AEP studied analyst reports and press comment.

Resolution of audit issues

90. Audit issues were resolved at the appropriate level of management. If an issue arose in an overseas business, the first stage would be for the local audit team to discuss it and seek to resolve it with the local management. Any significant issues were escalated to regional and then Group teams. This would occur where something was not resolved satisfactorily, but more often than not the issues that were flagged to the Group auditors were where there was an uncertainty that needed a considered judgement, which accordingly should be discussed with the Audit Committee.

91. The AEP gave detailed referral instructions to each territory and these required reporting of both resolved and unresolved audit issues. The AEP's objective was to have visibility of any issue wherever it arose. This involved a lot of travel. The AEP and his Supporting Audit Partner had both visited the key territories: either for the audit close meeting or between audit periods to discuss important issues with local management, and to meet the audit team and understand the work that was being undertaken.

92. There were discussions on various matters where alternative approaches had been considered, but there had not been any unresolved disagreements between the AEP and management. All key judgements were taken to the Audit Committee. In his five-year tenure, the AEP had never had an issue where management argued for one treatment and he argued for another by the stage of the Audit Committee.

93. [✂]. The actuarial judgements involved and the complexity of the various lines of business that the company wrote meant there was a degree of estimation difficulty that was particular to general insurance businesses. A significant proportion ([✂]) of the business was overseas and the complexity of understanding and evaluating the likely level of claims in different jurisdictions under different regimes was significant.

Auditor selection

The appointment of the current auditor

94. The AEP's understanding was that the company had requested firms to tender as they viewed appropriate. All the Big 4 firms had been invited to tender for the company's audit. He assumed that no Mid-Tier firms were. He was not aware of the circumstances leading to the tender.

95. The company's audit was seen as a very important audit for the current auditor to win. This was because the company was the [✂] insurer and the current auditor did not have such a company in its portfolio [✂].

96. The AEP explained that there was considerable research that went into an audit tender. At the heart of this was listening to what the client wanted and building a proposition around their needs. This was key to winning tenders. The current auditor attended 25 meetings with the company in a short period, as well as significant internal thinking time. It was a huge effort.

97. All audit tenders required an internal check as a matter of course of existing relationships and potential conflicts. The reputation of the potential client was hugely important to the decision as to whether to bid or not and this was a crucial part of the internal risk management process. With a FTSE 100 client it would be unusual to see any reputational risk but each case had to be considered on its merits.

98. There were multiple decision makers and stakeholders at the company whom the current auditor needed to impress in order to win the audit. The CFO held a key role but in addition there was also the finance team to which the current auditor had access and which would contribute to the company's views. The management team gave a recommendation to the Audit Committee which had the final say.

99. The AEP said that only the company could say why the current auditor had won the tender. He thought that the current auditor in the way it went about the tender process had demonstrated a businesslike and responsive manner, the breadth of its expertise, the ability of the team to take advice and make decisions and its cultural fit.

100. The audit fee was not negotiated until later in the tender process when the company had a shortlist of firms with which it could work. The AEP said that this was not untypical. The AEP said that he would not reduce the fee because the potential client was very important to the firm. When in a bid situation, the current auditor looked at the market rate and considered whether they could undertake the audit for that fee. There was no mechanical approach to pricing and no uniform profitability required on engagements. In this case, the fee was agreed on a country by country basis with reference to the incumbent's previous fee.

Annual reappointment

101. There was a formal process leading up to the decision to recommend reappointment or not. Management took soundings about the audit experience from the business and presented a management view to the Audit Committee, who also had views on the audit process and how it had been communicated.

102. There was always room to improve an audit. For example there might be issues where performance had slipped in certain territories. Pointing out issues was at the heart of the annual planning exercise.

103. The AEP thought that he was repitching every year. Whilst a base fee had been agreed for three years, this was on the basis that the current auditor was doing the job properly.

Fees

104. On appointment, the fee was fixed for a three-year period subject to no structural changes in the Group and with allowances for foreign exchange and inflation. However, the company had been highly acquisitive and so the base fee had increased to reflect the additional work. The fees for the acquisitions tended to be based on the fees previously incurred by the acquired business. The AEP said that the recovery rate had improved somewhat over time as the current auditor became more efficient but it had not improved as much as he would have liked.

105. Ultimately the CFO and AEP agreed the fees, but this was a detailed exercise and would usually include individual unit finance directors, the Regional Finance Director, other senior members of the finance team [✄] then the CFO. The current auditor mirrored this structure on its side. This was then presented to the Audit Committee, which established how the fee had been agreed and if management thought it was competitive. The ACC asked the AEP if he could do the audit to a sufficient quality on the basis of the fee. The ACC's concern was that the fee was sufficient not to cause any risk in terms of the quality of the audit.

106. The fees for the company had been benchmarked via the tender process. Additionally, companies looked at their peer group but this could be a crude check based on asset or profit measures. [✄] the AEP said they would be able to make some reasonableness checks.

Quality

107. Quality was achieved by taking a risk-based approach. The auditor focused on changes that might have affected the financial reporting. This included changes to key people, systems, accounting regulations, accounting policy changes and tax changes.

108. For the company's audit, which was international in nature, it was as important for the AEP to know the partners auditing in the major territories as well as he knew the UK partners: 'I need to know them, as individuals, I need to know the key members of their team, and I need to see them interacting with the client'. There was a requirement for a statutory audit in the key territories the company operated in so there were no issues in terms of agreeing the audit scope.

109. The company had a reputation for tight cost control but this had not resulted in the company pushing for a reduction in the scope of the audit. The pressure on costs came from the company as a whole, not just the CFO. The AEP thought that the ACC would also not want to pay more than necessary, but took more of a balanced view (ie had to ensure he was not paying too much but also that the audit responsibility was fulfilled in a professional way).

110. There had been no issues with restatement of the accounts.

111. The current auditors maintained a register of the key partners on the team and the stage of their careers. The first key rotation was the AEP himself as he could act for the shortest duration. Twelve months ahead of needing to rotate the lead AEP the current auditor spoke to the CFO and CEO about the process for audit partner

rotation. It selected three very senior partners to be considered by the company as a replacement, and all three were interviewed by the CEO, CFO and ACC.

112. The AEP said that a long-term relationship with an audit client should be the end product, not the start point. It was the result of doing a decent job in the right way. The benefit of a long-term relationship was that it gave insight into how that business was run, what its strategy was and where it was going, and where the key issues were. If the company was a market leader, it gave a great view of what the market was doing. He considered that the other Big 4 firms were knocking on the door every day (the AEP said the company told him this and he saw the other Big 4 firms winning non-audit work) and so the current auditor had to perform to maintain the relationship.

113. More time must be taken in the first year of an audit to ensure an understanding of the company.

114. Innovation and value add were by-products of the audit process. These were the observations that auditors were able to make about the company. For example, the auditor may be able to point out areas where competitors were doing things slightly differently, [✂]. The current auditor provided an annual 'Control observations report' to the Audit Committee.

Non-audit work

115. The current auditor provided the company with two sorts of non-audit work: (i) work in relation to transactions which would go to the auditor and (ii) some consulting services. There was a Group procurement function at the company and all non-audit services went through that process. It was on the list of preferred suppliers for certain services and had to compete on a job-by-job basis. The current auditor saw the rest of the Big 4 providing non-audit work at the company regularly.

116. The AEP did not think that being the auditor gave the current auditor an advantage in winning non-audit work. He said that he had a list of assignments where it had been disappointed.

117. Internally at the current audit firm there was a system to check whether the non-audit work was a prohibited service. The AEP had complete visibility over other services provided to the company by the current audit firm and the fees charged for these services.

The former AEP's view

118. The former AEP [✂] trained with the previous auditor [✂] in the general audit practice. Later the former AEP specialized in financial services working on large listed banking and insurance clients. The former AEP had also held positions within [✂].

119. Concurrent with being the company's auditor, the former AEP was the previous auditor's Insurance sector leader and was also the audit partner for a large insurance/financial services company [✂] which was then moving to a FTSE listing.

120. Over the former AEP's career as an audit partner the former AEP had audited around 12 FTSE 100 or equivalent[1] clients.

Relationships

Management

121. The previous auditor had been the company's auditors for many years. The former AEP's first audit for the company was the 2005 year-end. The former AEP was selected for the role in summer 2004. During the intervening period, the former AEP did not work on the company's audit but was involved in the Sarbanes-Oxley and IFRS conversion work that the previous auditor had conducted for the company. This provided an opportunity to get involved with, and build an understanding of, the company prior to becoming the audit partner.

122. The former AEP had got to know the management team through the work the former AEP had done for the company in the year prior to becoming the audit partner. In addition, the former AEP knew the company's CFO due to his prior role at another of former AEP audit clients.

Audit Committee

123. In terms of the handover between the previous auditor partners, the former AEP attended at least one Audit Committee meeting before taking over as the audit partner and the previous audit partner was available in the following year if the former AEP needed to understand a particular treatment but he had no formal role on the audit. The former AEP had met the ACC through attendance at those audit committee meetings.

124. In the former AEP's tenure, the former AEP had not had reason to approach the ACC for support to persuade management into agreeing a particular accounting treatment: as with any audit, management had a clear incentive to resolve issues to the satisfaction of the auditor prior to presenting the financial statements to the Audit Committee, and although sometimes issues had gone to the wire, they had always been resolved with management prior to Audit Committee meetings. The Audit Committee were always there as a form of 'threat' if there were issues but this had not been necessary at the company. The previous auditor had met at least once a year with the Audit Committee without management being present. The former AEP also met with the ACC on an ad-hoc basis to catch up on the business in general.

125. The former AEP noted that at some companies the ACC and audit partner met regularly and at others they would just meet at the Audit Committee meetings. The level of interaction varied and was dependent on the personalities involved. Some CFOs may have been nervous about audit partners and ACCs meeting separately; as they were aware the ACC may seek feedback on their performance from the auditors. However, there was nothing CFOs could do to prevent such meetings: if the ACC and audit partner wanted to meet (for example, if either had a concern, or simply wanted to exchange views on matters) then they would do so.

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[1] Note many large financial services clients were not listed in the UK, as they had foreign ownership and so a wider comparison is more appropriate (ie wider than just FTSE clients).

Shareholders

126. The former AEP had no discussions with shareholders during the former AEP's tenure. Auditors were not able to speak to individual shareholders directly due to confidentiality/insider trading concerns, so could basically only speak to shareholders through the company. The former AEP recalled a question being asked at the former AEP's first company AGM regarding the length of tenure of the auditors and the company had explained that it kept this under review and that the former AEP had just rotated on to the audit. In general, it was very rare for there to be a question about the audit and shareholders would approach companies rather than the auditors directly if they had any concerns in relation to the audit.

Resolution of audit issues

127. [✂]. The 2001 financial market crash had not helped matters and the company faced financial challenges. [✂]. The management team was focused on putting things right: they wanted to uncover any historic issues and deal with them. They also went through a process of [✂] cutting costs and restructuring the remaining business.

128. The company's accounting issues were complex both in terms of (i) the restructuring and valuation of businesses and (ii) insurance was a complex industry with accounting treatments, particularly [✂], that required significant judgement (iii) multiple GAAPs as they were an SEC registrant and reported under UK and US GAAP. In addition IFRS was being implemented. These various factors together made for a highly complex audit—in the former AEP's view, the number of difficult accounting issues the company had faced in the couple of years the former AEP was lead auditor were greater than at any of the former AEP's other audit clients.

129. IFRS implementation was a particularly difficult issue for all companies because it required application of new regulatory standards without any reference point from previous precedent. Because no one had applied IFRS before, the previous auditor was required to consult with, and refer a number of matters back to its internal team of experts as it was setting a precedent by agreeing particular treatments at the company. This resulted in some decisions taking longer than normal within the audit process. [✂]

130. In general, the auditors tended to agree treatments with the management team first. This was no different at the company. The typical process was that management would propose a particular treatment to the auditors. The auditor would consider this and then either agree or inform management if it had concerns. As above, any issues would generally be resolved before they needed to be presented to the Audit Committee. At the Audit Committee meeting management would present the areas of judgement in the financial statements, explaining issues in terms of the different range of realistic approaches available (eg, 'on the one hand, on the other hand') and then explaining the treatment that had been agreed with the auditors. The former AEP said that management teams would not always explain to the Audit Committee the full detail of discussions with the auditor, but would simply present the view as agreed following discussion with the auditor. The AEP would be present at these meetings, and the fact the former AEP could intervene would mean that management would not say anything inconsistent with what had been agreed with the auditor.

131. The former AEP said that is was rare for the Audit Committee to make the final call on an accounting issue. Management teams usually presented what they had agreed with the auditors as the answer. If for any reason the auditors and management

could not agree then this would be raised with the Audit Committee, although (as above), this had not occurred at the company.

132. The former AEP considered that Audit Committees generally had less technical accounting experience than management teams (who were dealing with technical issues day to day). Audit Committees tended not to get involved in the detail of the treatment of particular accounting issues. Audit Committees had to have relevant financial expertise to be able to provide a broad overview and apply common sense to the audit process, but would not generally have the specific technical knowledge of auditors and management. Because Audit Committees have to rely on the CFO, they need to be able to judge whether the CFO is competent or not. On occasion they will seek the auditor's views on such issues, [✂].

Other regulators

133. We discussed whether the auditors had much involvement with the FSA on a client such as the company. The former AEP explained that the FSA was not involved in the preparation of the accounts or the audit. For an insurance company, a regulatory return was prepared off the back of the accounts but this was a report for the FSA and the FSA was not directly involved in the workings of the audit or the valuation of parts of the business.

134. Companies authorized by the FSA, such as regulated insurance companies, were required to notify the FSA of any change in auditor, and a condition of FSA authorisation was that the company appoint auditors who have sufficient experience in the areas of business to be conducted. The auditors would also be interviewed by the FSA as part of the FSA's ARROW (Advanced Risk Response Operating Framework) review, where the FSA periodically went in to look at the operations of regulated companies. The auditor's views in such contexts may have provided useful insights to the FSA as regulator.

Switch to the current auditor

135. The previous auditor was told formally by the company that there would be a tender process in [✂ *date*]. However, the former AEP said that prior to [✂ *date*] it had not been an appropriate time for the company to change its auditors due to the various complex reporting issues it was having to address at the time. This was in particular because it had been going through IFRS conversion, Sarbanes Oxley (SoX) and other complex transactions—as the former AEP said: 'The last thing it needed (at that time) was new auditors'.

136. The timing of the tender during the period in which the [✂] accounts were being finalized had been challenging. [✂]. If the company wanted to have new auditors for the [✂] year-end, it needed to run the tender process in January [✂ *date*] to allow new auditors time to work on that year's audit. If the company had waited until the summer, then the new auditors would only have been appointed for the [✂ *date*] year-end.

137. As above, the consequence of the tender timing was such that the audit tender process was run at the same time as the company's accounts were being finalized. In this context, the former AEP had to be aware of potential independence issues in retendering and ensuring the previous audit firm's desire to be reappointed did not compromise the quality of the audit work which was being finalized. In addition, whilst normally junior members of the audit team would be heavily involved in the tender process, eg in preparing documents, attending meetings, dealing with admin related

to the tender process etc, in this case other staff from the firm had to do this as the audit team were very busy finalizing the audit work ahead of the auditor's report.

138. As the incumbent auditor knowing that there was likely to be a tender, its priority was to continue to provide a high quality service to its client, as by continuing to do a good job for the company in the period [✄] to [✄] it had the best chance of retaining the audit. The former AEP was clear that the previous auditor did not 'roll over' on any accounting treatments in order to seek favour with management—it was not worth risking the previous auditor's broader reputation by compromising on quality and increasing the risk that something would not be spotted or properly addressed in order to build favour with management. The former AEP did not believe that there were any specific changes that the previous auditor could have made to its service offering in order to avoid a retender process. The previous auditor had made changes [✄], but the former AEP believed that these changes were not going to change the perspective of the [✄] management who were keen at the least to test the market.

139. Once the tender was announced, the former auditor had a conversation with management to ascertain whether it should participate. A partner of the former auditor who was not involved in the audit approached the company to understand whether there were any issues with the current partner and team that could have been addressed to improve its chances in the tender. It was told by management that they went into the tender with a chance of succeeding. The costs of undertaking a tender process for both the audit firm and company were high and the former auditor did not want to waste anyone's time—and did not believe the company would have encouraged it to participate if it did not think it had a realistic chance of winning. The former auditor was assured that it would be considered a serious contender in the process.

140. As was typical, those invited to tender were able to meet with management prior to submitting the tender document. As an incumbent, the meetings were not about getting to know the company and the management team, but were an opportunity to listen to the client as the customer and understand how the offering could be improved. As the previous audit firm was able to speak to 10 to 12 people during this process it received more wide-ranging feedback than was typically received in the annual auditor appraisal. This feedback suggested [✄].

141. The previous auditor was aware that it was competing against the other Big 4 firms. The former AEP felt that [✄]. The former AEP felt that only the four largest firms were invited to bid due to the complexity of issues in the audit and because the company required industry specialism in each country in which it operated. The former AEP felt that the company must have believed no other firms could provide this global insurance capability, and hence not considered them for the tender.

142. The former AEP noted that the current auditor at that time did not have many significant insurance audit clients in the UK. The former AEP considered it likely that [✄]. There was no suggestion that there had been anything wrong with the accounts or the audit, [✄].

Subsequent interaction and other services

143. Following the unsuccessful tender, the former auditor had a number of meetings with the company to try to understand why it had not been successful. The feedback received from the company was consistent with the views expressed by the former AEP above.

144. Whilst it was auditor the previous auditor had provided limited non-audit services to the company. It had always undertaken some tax work for the company (and this had continued following the previous auditor's [✂] resignation as auditor). This was work that was won on the basis of the previous auditor's [✂] tax experience and was not related to the audit. In addition, during the previous auditor's [✂] time as auditor, non-audit fees had been received for Class 1 transaction work (which at times had been fairly substantial due to the volume of activity). This work was work that would typically be undertaken by the auditors and so had stopped since the previous auditor had ceased the audit. The former auditor had not been appointed on any large consulting projects by the company following the loss of the audit.

145. In the years immediately following the appointment of the current auditor, the previous auditor did not target the company's audit to try and win it back. [✂] The company's audit was therefore not high priority [✂].