# STATUTORY AUDIT SERVICES MARKET INVESTIGATION

## [Company D]

## Background

1. [Company D] (the company) was a FTSE 250 industrial products business that operated worldwide with major operations in Europe, the USA and Asia.

2. It was ranked at [✂] in the FTSE index (it had been listed on the LSE since [✂] and had been a member of the FTSE 250 index since the index originated in 1992). The company had revenues of £[✂] million and profit before tax of £[✂] million in FY2011.

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

4. The company's current auditor (a Big 4 firm) [✂] had been the auditor since 2003 when it took over from another Big 4 firm [✂]. Prior to 2003, the previous firm had been auditors for over 20 years. The audit fee for 2011 was £[✂], with the current auditors providing additional services to the value of £[✂] (the majority, £[✂], being tax services). The company's auditors audited the overseas subsidiaries as well as the Group.

## The Finance Director's view

5. The FD [✂] trained at a Big 4 firm of Chartered Accountants [✂] and moved into industry immediately after qualifying. He joined the company as Group Financial Controller.

### *Relationships*

*AEP*

6. The company had approximately [✂] operating companies (each of which was audited by the company's current auditors) which were run on a largely autonomous basis. In general he saw a commercial benefit in long-term relationships with advisers who knew the company well, which was important given the complex company structure, but he viewed the audit slightly differently.

7. The company sought to maintain an 'arm's length' relationship with the auditor at a Group level and so the FD was relatively indifferent as to which firm provided the audit. In his view 'there was always that genuine possibility of making a change, because as a Board we do not need that to be, and we do not want that to be, a cosy relationship. We want it to be a high-quality and good-service-delivery relationship'.

8. The FD considered that he did not see the AEP an excessive amount. He explained that he saw the AEP on a more frequent basis around year-end and half-year reporting and Audit Committee meetings. Outside these periods, he met with him every two to three months. The FD noted that there was a continual dialogue between the Group Financial Controller at the company and the audit firm's Director at [✂]. It was at this level where discussions about changes in accounting standards, compliance issues, and possible problem areas were held.

*Audit Committee*

9. The FD met the Audit Committee at three set meetings per year, for which he prepared detailed briefing notes. In addition he met the ACC every couple of months. The FD raised issues with the ACC in between meetings as necessary, either by email or by telephone. Typically this occurred four to five times a year. This included instances where the FD needed approval from the ACC for the company's current auditor [✂] to provide non-audit services (see paragraph 44).

*Shareholders*

10. The FD had not discussed the audit or choice of auditor with shareholders. Shareholders had not raised either as an issue. The company communicated its policy on auditor selection through its Annual Report which included a section on auditor appointment and independence.

11. The 2011 Annual Report included a section setting out the responsibilities of the Audit Committee, the sign-off policy for non-audit service provision by the current auditors and a section explaining that the company and Current auditor had undertaken a joint evaluation which the Audit Committee felt was sufficient not to require a full tender process at this time (see paragraphs 24 and 25).

12. There had been no comment from shareholders on the change of auditors in 2003.

## *Resolution of audit issues*

13. If the current auditors raised an issue on an accounting treatment judgement, then the finance team would research the area to see what treatments were adopted at comparable companies. The company was looking for a commercially sensible outcome that fitted within the accounting rules. Even though this was a technical area the FD involved the CEO in discussions to make sure the commercial perspective was considered. There would then be a mature discussion with the current auditors to reach an opinion that all parties were satisfied with (ie one that met the rules and was a fair reflection of the commercial position of the business).

14. To date there had been no major confrontations and the company and current auditors had been able to come to sensible agreements. These types of issue were brought to the FD's attention quickly and typical areas for discussion were: Annual Report disclosures, areas where the accounting rules had become more complex (and in the FD's view, less logical in some instances), or where there had been an acquisition and goodwill and/or intangible assets needed to be accounted for.

## *Auditor selection*

15. The FD described his role in auditor selection as involved and influential, but as part of the Board. He noted that he was the key relationship holder with the current auditor.

*The selection of the company's current auditors [✂] in 2003*

16. The previous auditors [✂] had been the auditors for over 20 years. The company was happy with the quality of service but felt that the service had become 'a little tired' and needed invigorating. However, the main driver of the decision to tender was the previous auditor seeking a substantial (60 to 70 per cent) increase in the

audit fee. The rationale for this appeared to be a step change in their required recovery rates over a short period and was not related to changes in the company's business. The FD felt that the company was not able to have a sensible dialogue with the previous auditor on this despite what had previously been a very sensible, open relationship. This was a trigger for the company to test the market.

17. The FD and the Group Financial Controller had face to face interviews with audit partners from all of the Big 4 firms to understand their capabilities. They discussed: the team that would work with the company and their status in the audit firm, their experience, their understanding of the audit process for the company including the international dimension, the audit deliverables, the value added that the audit firm could include (experience with other companies both inside and outside the sector was a feature the FD felt would add value for the company), how they would manage the transition from one auditor to the next, the fees and the general rapport and fit.

18. Following these preliminary interviews, the FD put a proposal to the Audit Committee recommending that three Big 4 firms be invited to tender formally ([✂]). He felt that whilst the other Big 4 firm [✂] was capable of doing the job they had the least good fit (ie culture and style of working) and that three firms provided a sufficient choice for the Audit Committee to review: the Audit Committee accepted this. The three firms were invited to tender and made formal presentations to the Audit Committee.

19. The objective of the tender process was to receive an audit with no diminution in quality, scope and output compared to the current audit and to ensure that the fee achieved value for money. The Audit Committee review concluded that the company's current auditors should be selected because of its ability to deliver an audit without compromising service levels and with efficiency gains passed on in the fee. The fee pitched by the company's current auditors was slightly less but broadly comparable to the previous auditors' historic fees. The FD considered the service levels to be very comparable and felt the transition was handled well by the company's current auditors and the company.

20. The FD ranked the factors involved in the decision to appoint the company's current auditors as follows:

*(a)* quality of the Audit partner and team—experience and standing within the audit firm [✂];

*(b)* fit with the company and understanding of the Group;

*(c)* efficiency of the proposed audit process;

*(d)* price relative to the previous auditor [✂] (although he noted that the selected auditor's [✂] proposal was comparable with the other bidder [✂]); and

*(e)* quality and thoroughness of proposal/presentation.

21. A change resulting from the switch was greater sharing with the current auditors of the company's internal audit work. There was an arm's length relationship between the previous auditor and the internal audit team, but the company's current auditors were more persuasive in terms of the value of sharing the company's internal reviews—they could be discussed rather than each performing work in isolation. The company's current auditor also took a more active role in the Audit Committee meetings and was more active at briefing and interacting with Audit Committee members. The FD felt that this was a change that needed to happen.

22. The fee agreed with the company's current auditor included a £[✂] reduction (approximately 10 per cent of the base fee excluding expenses) for the first three years and then increased in the fourth year. It was not part of the initial tender proposal but was negotiated during the tender process prior to the presentation to the Audit Committee and the company's current auditors' selection.

### *Auditor reappointment*

23. There was an annual reappointment process as required by the Companies Act. The FD characterized this as a 'relatively quick look annually, probably a more thoughtful look every two or three years, and then really a more detailed review every five years'.

24. Since the current auditors won the audit there had been audit partner rotation. The original partner rotated off the audit in 2008 and was replaced by a very able new partner. However, in 2010 the new partner was seconded overseas. This, coupled with the company's routine two to three year consideration of the auditors, led it to ask the current auditors to undertake an informal retender. The company asked the current auditors to consider all aspects of the audit process and to pitch to the Audit Committee. The Audit Committee would judge the new approach and if it was not satisfied the audit would go out to a broader tender process.

25. The FD explained that the company and the current auditors looked at what the company's peers were doing, looked at the fees, looked at the deliverables and the value added coming from the work, and looked at the audit approach. The current auditors presented a detailed document and detailed presentation to the Audit Committee and on the basis of this the company was content to continue with the current auditors and not go out to tender.

26. The benefits of this process included: an improvement in efficiency whereby there was more rotation year-to-year of subsidiaries which did not require a statutory audit, a freezing of the fee for two years and more access to the current auditors' commercial briefings, for example the current auditors presented at the company's European FDs conference on a commercial topic.

27. More generally, the FD thought the company experienced 'competitive behaviours' from its current auditors and the other Big 4 firms which gave the FD comfort in the relationship.

### *Awareness of other options*

28. The FD explained that the company discussed Mid Tier firms during the tender process but decided not to engage actively with them. The main reason was geographic reach: the company had about one-third of its business in the UK, just under one-third in the USA, 20 per cent in Europe and the rest in Asia and other regions. The FD was keen to ensure consistency across the world and did not feel that a Mid Tier firm could provide this.

29. The FD's other concern was how a Mid Tier firm would be perceived by shareholders. He thought that they might be uncomfortable with a Mid Tier firm. However, this was just a gut feel and not something the FD had tested. He thought that if a Big 4 firm could provide the scale, strength and depth required by the company then there was no need to look outside the Big 4. The FD noted that general practice was to use a Big 4 firm. While he was happy to explore alternative solutions using the Big 4 was the safe option. There was less to worry about or

justify, and using a Big 4 firm was in line with all the company's peers and the companies that it came into contact with. Choosing a Mid Tier firm could make it the odd one out.

30. The company had not received any unsolicited bids for its statutory audit work. The FD maintained a regular dialogue with the other Big 4 firms. He had meetings with audit partners from these firms about three times a year. The company used the other Big 4 firms, [✂], [✂] and [✂] (albeit to a lesser extent) on the provision of tax and due diligence, therefore the Group Financial Controller had regular contact with these firms in relation to these non-audit services.

31. The FD's interaction with the Mid Tier was occasional and was typically on specific topics such as a particular angle on tax advice, pensions or bribery and corruption legislation.

*Switching costs*

32. In terms of auditor transition and change, the FD said that frequent change could be disruptive. He thought that the change in auditors from [✂] had been smooth but that it took time to manage. Audit partner change had generally been very well managed. There was a period of the incoming partner shadowing the outgoing partner to ensure smooth transition.

### *Fees*

33. The company determined the scope of the audit and set out its expectations for coverage (the proportion of revenue and profit the audit would account for) before negotiating the fee.

34. The scope was more flexible for the company as it operated to some extent in countries with no statutory audit requirement eg in the USA. The FD explained that ISA 600 required that auditors covered a sufficient element of the Group in the audit. Where there was no statutory audit requirement, the company rotated the subsidiaries receiving a full audit. In a given year certain subsidiaries received a full audit and others a less detailed review, the schedule of which changed annually (see paragraph 86). The FD understood that the company's audit coverage was more than sufficient to meet the requirements. The rotation was driven by the company's risk assessment, its review by alternate means including Internal Audit and internal senior finance personnel peer review, and partly by cost management.

35. The FD had a detailed discussion of fees every year, although occasionally the base fee might be agreed for a couple of years. The starting point was the previous year's fee. This was adjusted to reflect: changes in accounting standards and compliance, changes in the company's business (eg acquisitions and any extra work required in auditing the valuation of intangible assets), and inflation.

36. In addition to this top-down review, there was bottom-up pressure on the fee from the company's subsidiaries. The fee was agreed by the Group but was charged to the subsidiaries, which had incentives based on their own performance. The subsidiaries raised concerns if they though the audit fee was too high or if they were aware of a more economical alternative.

37. The FD periodically benchmarked audit fees against other companies, although he recognized that each company was structured differently. The company discussed the fee with its current auditors [✂] to understand what was happening in the market

more generally and what part inflation and scope changes should play. The FD had discussions with audit partners from other firms every year, which included a discussion on the audit fee to see if was broadly sensible or not.

38. The FD explained that the scope of the audit was always set first, with the discussion of the fee after. Once provisionally agreed between management and the auditor, the fee was presented to the Audit Committee which typically accepted it.

### *Quality*

39. In most years, the company sent a survey to its subsidiaries to rate the quality of the audit. Most recently, it was undertaken in conjunction with its current auditors. The survey covered topics such as meeting deadlines, understanding the local businesses, the audit team continuity and performance, insights provided by the audit team. It sought to highlight the positives from the audit and areas where the audit could be improved. For example, a concern in one country last year was that the audit had not been as efficient as it could have been and that the company did not benefit from the level of knowledge and continuity it expected.

40. In terms of insight, the FD was looking for the experience the auditors had of good practice in other businesses and to see how that might be applied to the company. The FD thought the company was quite demanding in terms of overall quality assessment. The FD, ACC, Group Financial Controller, Company Secretary and another NED were all qualified accountants and all but one had experience in auditing which made it easier to understand whether what the company was getting was what it should reasonably expect.

41. The FD looked for clarity and logic from the auditors on technical issues. He found the company's current auditors to be thorough and knowledgeable on technical changes. This was where the relationship between the company's Group Financial Controller and the Audit Director was important as it gave the company sight, warning and opportunity to discuss the new things that come in.

42. The FD thought the company's corporate culture paid great attention to detail and so he would not expect the auditors to find misstatement in the accounts. On presentational issues he noted that the company had been subject to an FRRP review about 18 months ago and that this had highlighted two points on the accounting policy disclosure that could be improved and a set of other minor disclosure matters to think about. The FD's impression was that this was a relatively benign report suggesting that the company was doing the right thing. The FD was not aware of the reasons for the FRRP selecting the company for review; he assumed it was a routine matter.

### *Non-audit work*

43. The company had a strict policy on using its current auditors for non-audit services. Its general preference was to not use the current auditor for non-audit services but there were things that were best done by the current auditor, for example certification of facts, certain tax work and in some cases due diligence on acquisitions overseas etc.

44. The company's policy was to limit non-audit work performed by the current auditor to less than 100 per cent of the audit fee. At each Audit Committee there was a summary of non-audit fees spent so that they could keep a track on it. In addition, work over £50,000 had to be agreed by the Audit Committee and work over £100,000

could only be given the current auditor following a tender process. There were two reasons behind these rules: (i) the main one being to avoid any conflict with the auditors' independence and (ii) also to keep things competitive by having a relationship with, and sharing work around, a number of firms.

45. The company took a fairly hard line on this and considered it right to be restrictive in the work given to the current auditors. The FD noted that provision of consulting by auditing firms seemed to be creeping back into the market and indicated that he was not comfortable with this. He felt it was right to be reasonably restrictive. However, the FD noted that there was a commercial cost to this as the current auditors knew the business and the understanding they had often made them best placed to do the work which the policy in some cases prevented.

46. The FD noted an instance where the company required some buyer due diligence work in Finland and as one of the Big 4 firms was selling the business and another was the auditor of the target company, there was in effect only a choice between its auditors and one other (as in that region there were no other international providers familiar to the company).

## The Audit Committee Chairman's view

47. The ACC [✂] joined the company's Board as a non-executive director (NED) and Audit Committee member in [✂ *date*]. She became ACC in mid-2008. The ACC was an executive Finance Director (most recently for a private equity backed company) and had no other NED roles. She trained with a Big 4 firm [✂], and left on qualification in [✂ *date*]. During her career she had worked with a range of auditors including Arthur Andersen, Deloitte, KPMG, EY, PwC, Grant Thornton and a small local firm.

### *Relationships*

#### *AEP*

48. There were three Audit Committee meetings per year and the ACC met the AEP before each meeting to discuss the issues to be raised and to allow the AEP a one-on-one discussion without management present. Audit Committee meetings were held in [✂ *date*] (with the year end being in [✂ *date*]).

49. There had been no instances where the AEP needed to raise issues to the Audit Committee without first discussing them with management, but the ACC thought that the AEP would do this if necessary.

#### *Management*

50. The Board met every couple of months. In addition there were other meetings, including the annual strategy meeting. The ACC talked to the FD before the Audit Committee meetings and important events and was often in contact via email. The ACC described her relationship with the FD as good, but independent from him. She thought that as an FD herself there was a natural bond with the FD. Before Audit Committee meetings they discussed areas such as the audit fee, audit planning or independence. The ACC thought it might be more comfortable to discuss these issues on a one-on-one basis first so at the Audit Committee they were both on the same page.

*Shareholders*

51. The ACC had no interaction with shareholders apart from the AGM. Shareholders had never raised any issues about the audit or choice of auditor.

## *Resolution of audit issues*

52. The ACC had no examples of audit issues at the company where management had fundamentally disagreed with the current auditors and that there was no conflict between them.

53. The Audit Committee received a full briefing report prior to the audit detailing the audit plan and scope. It also received a briefing pack at the year-end setting out the areas of risk that had been reviewed and any issues raised, with suggestions as to how they might be resolved.

54. The ACC noted there was a requirement that all adjusted audit differences (ie where management had accepted changes to the accounts proposed by the current auditors in light of their reviews) were notified to the Audit Committee, and that more material items were discussed by the Audit Committee. She did not think it was appropriate for the Audit Committee to discuss very small items.

*Audit Committee resources*

55. The ACC's time commitment included the three Audit Committee meetings, plus another day and a half in advance of each of these preparing and meeting the FD and AEP. She also received ad hoc calls from the FD when he wished to use the current auditor for non-audit services and required approval. The other Audit Committee members spent similar time, apart from meetings with the AEP and FD.

56. The ACC thought that the Audit Committee at the company had the resources and expertise to scrutinize the current auditors and management. The ACC was a current FD, one member was CIMA qualified and two other members had financial backgrounds.

*Stakeholder roles*

57. The ACC saw her role on behalf of the shareholders to make sure that management was managing the business and that the results were credible and reliable. The current auditors' role was to make sure and sign off that they think the numbers are true and fair. The ACC thought that the Audit Committee's role was to address any issues that were raised as a result of the audit process and to act as a safeguard between the management and the shareholders to help the shareholders to have some confidence that the numbers are true and fair.

58. The ACC explained that the FD had a key role in ensuring the accounts were true and fair, although this was the responsibility of the whole Board. In doing this the FD needed more dialogue with the current auditors than the ACC did, and so the AEP and FD necessarily had a closer relationship than the ACC and the AEP. The ACC's role was to review rather than produce the accounts, and to ensure that the current auditors remained independent. She thought that audit partner rotation assisted with this.

## *Auditor selection*

*The current auditor's retender in 2010*

59. The current auditor was first appointed in 2003 before the ACC was a NED. When the ACC assumed the role, she raised the question as to whether the choice of auditor was appropriate in terms of independence, service, value and ability. It was not because there had been any issues, rather it was due to the length of tenure. The ACC wanted to make sure that the auditors were still spotting things and they were actually still vigorous on the audit. She thought that Audit Committees should continually ask themselves whether they were getting the best possible audit.

60. The Audit Committee discussed holding a full tender in 2010, but chose to ask the current auditor to retender and prove why its audit offering was competitive and to refresh its approach. The ACC thought that it was not necessary to look to change the auditor unless there was an issue with a particular AEP or the audit itself. She thought that the retender process prevented the current auditors from getting complacent and considered that doing this every four to five years was about right (unless there were any specific concerns or issues regarding the audit).

61. The Audit Committee benchmarked the current auditor's performance against its own knowledge of other auditors. For example another Big 4 firm [✂] audited the company where the ACC acted as FD, and so she could make comparisons.

62. The Audit Committee decided annually whether it was comfortable with the choice of auditor. There was no annual questionnaire to the company on this, rather informal feedback by way of discussion with management and the Audit Committee.

*Switching costs*

63. The ACC thought the monetary cost of switching auditor would normally be very small as she would expect the new auditors to absorb the initial costs of getting to know the business. The real cost in switching auditor was in management's time, as the first year of an auditors' appointment required significant input from both the executive management and the NEDs.

64. The ACC considered that as long as the auditors were independent then it was good for shareholders and management to have an auditor who understood the business and was able to identify the risks. The risk of switching auditors was that they did not immediately understand the business.

*Awareness of other options*

65. The ACC thought that there was a significant gap in terms of coverage (but not skills) between the Big 4 firms and the larger Mid Tier firms. The ACC said that the quality of the accountants in the Mid Tier firms was the same as in the Big 4 firms. She based this on her experiences of recruiting finance teams, taking former employees of both the Big 4 and Mid Tier firms. However, she considered that given the company's international reach the Mid Tier would not be able to conduct the whole audit and it was an advantage to use only one firm. Mid Tier firms were used by the company for specific specialist pieces of advice on non-audit work.

66. The ACC thought that shareholders and banks also preferred a Big 4 firm to sign the accounts. The ACC noted that in another role (working for a start-up business) as the company had grown they had switched to a Big 4 firm not because of any explicit

requirement by shareholders or banks but because it was the predominant view held by people in the market that larger companies should have a Big 4 auditor (ie it was the norm). The ACC said that it is a commonly held perception in the market that the Big 4 were more credible and therefore that it was safer to use a Big 4 firm.

67. The ACC was uncertain regarding the current international scope of the Mid Tier firms and that at present there was no reason to change from the current auditor. If a tender was held in the future she would look at the Mid Tier firms to see if they did have the coverage the company needed. If they could prove they had the coverage and this was credible and not an issue to shareholders then she would have no issue with using them in principle. She noted that this view was a personal opinion and might not be shared by the FD or other Audit Committee members.

68. The ACC had not received unsolicited bids for the company's audit from any firm. She received regular marketing from all the Big 4 firms although could not be sure of whether this was due to her role at the company or due to her other roles.

### *Price*

69. The FD led the fee negotiations. The ACC considered the audit fee to be competitive and the Audit Committee considered whether it was appropriate (including whether it was too low to allow the audit to be conducted thoroughly).

70. Typical changes to the audit fee resulted from the company buying and selling subsidiaries, changes in regulation resulting in more work needing to be done, changes in the subsidiaries that needed to be audited (see paragraph 34), geographic changes and inflation. The ACC expected to see clear reasons why there had been changes, and comparisons with previous years as appropriate. She noted that when the current auditor retendered in 2010, it [✂] had offered a two-year audit fee freeze.

### *Quality*

71. The Audit Committee wanted to see that the auditors understood the key risk areas and assessed them sufficiently. The auditors also had to be comfortable with the company's treatment of the risk areas and that there were no material errors in the accounts. The ACC explained that the Audit Committee needed to be happy that it had a set of accounts that the business could sign off that were true and fair. In practice this meant they needed to be content that the auditors had performed a thorough job ([✂]).

72. She was not aware of the current auditors undertaking unnecessary checks. The extent of the geographic coverage of the audit was agreed on a rotational basis with the current auditors. The ACC thought the company covered more than was necessary, but this was as much a company decision as an auditor decision.

73. The ACC thought that service quality was dependent on the quality of staff and the audit process and delivery. The quality of the individual audit team members was more of an issue for the management on a day-to-day basis rather than for the Audit Committee itself.

74. In discussing innovation the ACC thought 'an audit is an audit'. She had seen many changes to the way audits were carried out, but the end product was the same. She said that audit processes needed to change to reflect the changing ways in which

companies compiled their accounts but it was about getting the same results. The main change had been in terms of IT.

### *Non-audit services*

75. The ACC's view was that it was beneficial to have the auditors provide tax services as they had knowledge across the company: she never saw it as particularly inappropriate to use the same audit firm to provide tax services. The company made a point of using other firms (ie not the auditor) to provide M&A advice and specialist services. The ACC considered the company had a very low use of the current auditor for non-audit services when compared to other firms. She noted that the company sometimes had to use the current auditors in jurisdictions where it struggled to find a suitable alternative.

76. The ACC said there was a general issue with conflicts, particularly on M&A advice where the number of advisers could be quite limited, as everyone wanted to use a different due diligence provider and some providers were conflicted out as the auditor. The number to go around could be small and Chinese Walls were sometimes needed so different teams at the same firm could be used.

77. The ACC thought that there could be a pricing and quality benefit to using the same firm for all services (she had experienced this in private companies with only one shareholder) as there was a better understanding of the business. However, she recognized the need for independence.

## The Audit Engagement Partner's view

78. The AEP [✂]. [✂] the AEP had trained with the firm/its predecessors. He was at the time the lead audit partner for two other listed companies [✂] and in the past had also led further listed company audits. [✂]. The AEP has worked with the company for 18 months.

### *Relationships*

#### *Management*

79. The company was a multinational business with approximately 40 to 50 units spread across seven divisions around the world. The Group audit involved contact with all seven divisions and the AEP interacted directly with management of each division through two or three meetings a year. The AEP also interacted with the divisional Chief Executives and Finance Directors two to three times a year. There was also regular interaction with staff at the Group headquarters in the UK throughout the year.

#### *Audit Committee*

80. Consistent with most large listed PLCs, the company had three Audit Committee meetings a year, which the AEP attended. The main auditor input at Audit Committee meetings took place at the half-year and year-end meetings (although the current auditor did not do a half-year review, it did do some limited private procedures that fed into a private report). The AEP always met or spoke to the ACC before the meetings to discuss the issues that would be reported to the Audit Committee. The AEP met the ACC once or twice on other occasions during the year.

81. The AEP thought that the Audit Committee had a good group of senior non-executive directors with substantial financial experience. The ACC [✂] had been an FD of listed companies and a non-executive director [✂] had a long history as an FD. The AEP thought meetings were well run and consistent with good practice. Audit Committee meetings tended to last three hours with presentations from Internal Audit, the FD and the current auditor.

### *Shareholders*

82. The AEP had no direct interaction with shareholders. The AEP attended the AGM but was not there to answer questions as these were directed to the Board.

## ***Resolution of audit issues***

83. During his tenure the AEP had not experienced any disputes with the company. The current auditor presented the main judgments made to the Audit Committee, and while there were discussions about these there had been no items resulting in a disagreement over their accounting treatment.

### *The audit plan*

84. The audit firm provided the company with a detailed plan of the audit process. The plan discussed the scope of the audit:

*(a)* The scope of the audit work classified by the coverage of revenue and profit.

*(b)* Levels of materiality—a level for the Group consolidation audit, a level for individual components and a level above which unadjusted misstatements were reported to the Audit Committee.

*(c)* The rotation plan for each business unit over a three-year period—whether the unit had a full scope audit (all balances), agreed upon procedures (review of significant balance sheet and income statement components) or a head office review (an analytical review).

85. The plan identified the key risks to the company, providing a description of what the risk was and how the current auditor would investigate it. The plan also described how the current auditor would consider fraud, understand the company's internal controls, the audit timetable and how the fee differed from the previous year.

86. The key risks identified for the company were:

*(a)* accounting for acquisitions;

*(b)* impairment of goodwill and acquired intangible assets;

*(c)* appropriateness of development costs capitalized and the recoverability of these costs;

*(d)* revenue recognition: sales cut-off and sales returns;

*(e)* judgements and key assumptions used in determining defined benefit pension obligations;

*(f)* recoverability of trade receivables;

*(g)* taxation; and

*(h)* management override of controls.

87. Audit scope was discussed intensively at the Audit Committee meetings. The company was not straightforward to scope due to the international structure of the group. The AEP discussed the level of coverage an audit achieved: approximately 70 to 80 per cent of revenue or profit received a full audit sign off. The remainder would be checked by analytical review of the results and testing of key ledgers, for example cash debtors or stock, for which some underlying information would be checked (see paragraph 84).

### *The audit report*

88. The final report presented to the Audit Committee contained a more detailed overview of the key risks (see paragraph 86), including relevant business statistics, and a description of the work the current auditor had done addressing each risk and its conclusions.

89. The report also included: observations and recommendations on the company's internal controls, disclosure deficiencies (where items needed to be considered differently to meet disclosure requirements), details of future accounting developments and the impact on the company and the management representation letter.

## ***Auditor selection***

90. The AEP joined the company audit team during a re-tender seven years post the current auditor's initial appointment (see paragraph 60). [✂]. The current auditor understood that the company had tendered the audit to allow the company to understand the following in relation to other providers [✂]:

*(a)* consistency of the audit fee with the market; and

*(b)* receiving appropriate added value through the audit.

91. The FD had a lead role in the retender but the decision was taken by the Audit Committee as a whole. The AEP thought the current auditor was successful at the retender as it addressed the company's points. It demonstrated through benchmarking with the company's main competitors that the audit fee was competitive. The company recognized the value in terms of client service the current auditor had brought over time across different units and demonstrated other areas where value added could be achieved through the audit. The process had taken place before the half-year report, which meant that the company would have had time within the financial year to switch auditor.

92. The company reviewed the current auditor's performance on an annual basis. The company issued questionnaires to the finance teams of each individual business and each divisional team. These were relatively detailed, focusing on how the audit was performed and whether it was efficient etc. The FD also conducted an informal assessment based on his observations at the Group head office throughout the year. His reports to the Audit Committee included his observations of the audit and its effectiveness.

93. The current auditor also conducted its own independent client care reviews for larger listed clients. These were not conducted annually but one had been done for the company in the last 12 months. A senior partner who was independent of the audit team met key stakeholders from the company and discussed the performance of the overall audit and individuals. This was then fed back to the audit team.

### *Price*

94. The starting point of fee negotiations was the previous year's fee. Variation in fee was mainly the result of a change in scope. Audit scope could change based on the number of subsidiary businesses to be audited (which varied due to rotational audits in the USA), acquisitions and disposals, and other changes to accounting standards or acquisition accounting.

95. In calculating the fee, input was required from all local offices for the worldwide work. Each of the company's subsidiaries was relatively small with an audit fee typically between £10,000 and £15,000. The individual fees are initially discussed at a local level with the local current auditor's office engaging with local management to understand the business before calculating the fee.

96. The fee was discussed at different levels of management. Most discussion was between the Group Financial Controller and the current auditor's Senior Manager. It was then discussed between the AEP and the FD before being presented to the Audit Committee for consideration.

97. The AEP said that there had been no threat of tendering in order to achieve a lower fee. He added that the Audit Committee took an interest in fees but the prime focus was ensuring the accounts were accurate and judgements were sensible.

### *Quality*

98. The AEP said that quality was embedded everywhere. He explained that the current auditor's training was updated every year to reinforce this and that the current auditor's partners had a quality dashboard so quality was 'everywhere in terms of what we think and do'. This approach manifested itself in terms of how the AEP performed an audit for the company.

99. To ensure quality across overseas offices, the current auditor used formal inter-office instructions for subsidiary reporting. There were calls with the main overseas offices at the planning stage and to discuss results. The AEP attended the main overseas meeting with the US to discuss results. A lot of detail was reported in writing from the overseas offices, which was analysed in the UK.

100. When rotating the AEP, the current auditor had proposed the current AEP as a candidate to the company but had made it clear that if he was not acceptable there were other partners available.

101. The AEP thought that the current auditor had an established team in the UK and locally and that consistency and continuity had been good. The most important aspect was spending time getting to know individuals at different levels. For example, in his first year the AEP had visited four or five of the company's facilities in the USA to meet local management. The company also hosted an event for internal networking. The AEP attended this event last year, particularly as he was new to the audit and wanted to meet as many people as possible.

102. The AEP gave examples of value added achieved through the audit. The current auditor ran a CFO programme for 'up and coming' CFOs of listed companies which the company's Group Finance Director had completed. There was also the [✂] which was available to PLC directors providing information on current events, corporate governance developments and other areas of development such as pensions. Generally the current auditor was expected to give feedback and insight into the business.

103. The AEP was not aware of any FRRP reviews in his tenure as AEP for the company.

### *Non-audit services*

104. The current auditor provided £[✂] providing tax services to the company in the last two years but was only one of a number of tax advisors to the company. The company had a policy where a non-audit service fee above a certain value £[✂] must be put to a competitive tender process (see paragraph 44). The current auditor had a one-to-one policy where a formal internal consultation on independence had to be held if total non-audit service fees were larger than the audit fee. There was no overlap between the firm's audit and tax advisory teams.

## The former audit firm's view

105. The former auditor [✂] thought that the sector the company operated in was not inherently high risk, but the structure of the company (which had many operating companies both in the UK and overseas) increased the level of audit risk. The former auditor found that the senior members of the Group audit team were increasingly visiting overseas subsidiaries to ensure that issues were appropriately identified and resolved. The costs of this put pressure on the level of the audit fee.

106. The risks of the company would have been manageable but the company would have needed to pay a higher fee at which the former auditor would have been comfortable it could perform a proper audit and achieved an acceptable level of profitability. The company declined the former auditor's request for a phased increase in the fee. The former auditor chose not to bid in the tender as it judged the prospect of winning the tender for an acceptable fee to be small.