STATUTORY AUDIT SERVICES MARKET INVESTIGATION

[Company J]

Background

1. [Company J] (the company) was a FTSE 250 investment trust. It was managed by [✂] (the 'management company' (MC)) and invested in [✂]. As an externally managed investment trust, all members of the board were non-executive directors.

2. The company had a market capitalization of approximately £[✂] million.

3. The company's major shareholders were institutional investors [✂]. It was primarily a retail investment trust as it had a large number of retail investors who invested in the company through personal ISAs etc.

4. The MC was appointed by the company's board to manage the company's assets (this included provision of accounting and company secretarial services in addition to fund management). The board could replace the MC, but not specifically the Portfolio Manager, as per the Management Agreement.

5. The company switched from a Big 4 audit firm [✂] in [✂] following a formal tender process. The audit fee for 2011 was £[✂].

The Fund Accounting Manager's view

6. The Fund Accounting Manager (FAM) was employed by the MC. The MC provided management, accounting, administrative and secretarial services to the company pursuant to the Management Agreement. He joined the MC in early 2011. He qualified as a Chartered Accountant in 1982 having trained with a small firm and worked for Coopers & Lybrand before moving into industry. He had extensive investment management experience in fund accounting roles and had been responsible for preparing financial statements and facilitating audits carried out by the current auditor and by all of the Big 4 audit firms.

7. As noted in paragraph 4, the MC provided management services to the company including accounting services. The FAM reported to the company's board.

Relationships with stakeholders

Auditors

8. The FAM was the main contact with the auditor for all day-to-day work. It was the responsibility of the FAM to prepare the financial statements to be audited. The FAM interacted with all members of the audit team, from junior staff up to the partner.

9. The FAM had clear visibility of the auditor's work as he answered many of the questions the auditors had. Two other members of staff reported to the FAM and helped the auditors, but issues were brought to the FAM if not resolved. He would be aware of any significant queries raised by the auditors.

10. The FAM did not spend a considerable amount of time on the audit itself; his work was mainly preparing the financial statements in advance of the audit. During the

audit he spent time responding to any queries the auditors had as they arose, and then attended two main meetings with the auditors to discuss and resolve any outstanding audit issues. He estimated this took about one day in total.

The Audit Committee

11. The FAM attended Audit Committee meetings where his responsibility was to present the accounts and answer questions from the non-executive directors. He said that, unless there was an issue related to fraud, he would expect to be informed of, and to have discussed, any significant issues with the auditors in advance of the Audit Committee meetings.

12. The FAM described his role as providing a high-quality service to the Audit Committee and board of directors. This included preparing the financial statements and other financial information for the board papers.

Shareholders

13. The FAM had no direct interaction with shareholders. Shareholder queries were directed through the Company Secretary and only questions about the accounts would reach the FAM. The FAM attended the AGM but would only answer questions where the Chairman requested him to do so. He saw his key role as making sure that financial statements were correct and as useful as possible for shareholders.

Resolution of audit issues

14. There had been no disagreements over accounting treatments during the FAM's tenure. Any issues would be raised with the FAM and resolved before an Audit Committee meeting, if possible. Significant issues would be explained to the Audit Committee so that it could decide what action to take.

Auditor selection

15. The decision to appoint the auditors rested with the board, therefore the FAM (and the MC in general) had no direct involvement in the appointment decisions. The board asked the MC how the auditors were performing, but it was the board's decision how to use the information. The shareholders vote at the AGM on a resolution to reappoint the auditors.

16. In assessing the auditors' performance, the FAM considered that two main issues, in particular, might lead to a review of the choice of audit firm: first, publication of something that was incorrect; and secondly, a lack of availability and approachability. For example, certain statements had to be cleared with the auditors within a short time frame before publication. The auditors had to be responsive to such requests. Audit fees were not so much of an issue as they were small compared with the overall size of the company. The FAM noted that a £[✄] saving in the context of a £[✄] audit might be a significant percentage saving of five per cent, but in absolute terms was not likely to be enough to trigger a change of audit firm on its own. The fee was reviewed against the audit fees of other similar investment trusts to ensure that it was competitive.

17. To the FAM's knowledge, there were no plans to review the choice of auditors. The FAM thought the current auditor provided a good service and if it was doing a good

job then there was no reason to switch. The FAM preferred to stay with an audit firm providing a good service rather than take the risk of switching.

18. If there were to be a switch, the FAM said that he expected the new audit firm to absorb any additional costs for the first year as part of the cost of winning the audit. He expected any new audit firm to be familiar with investment trust businesses and therefore thought new auditors should not need too long to understand the company. From the MC's perspective, there would be extra management time needed to explain the business and there would be some work involved in arranging a beauty parade and, possibly, attending the interviews.

19. The FAM had worked at companies with a policy of tendering the audit every five years, but he was not aware of such a tendering policy at the company.

20. The FAM had not received any unsolicited bids or approaches from other firms to undertake the company's audit. He did not receive significant marketing material from other audit firms. He was occasionally invited to training events run by other audit firms.

Fees

21. The audit fee was normally first discussed at the Audit Committee meeting before the year end. The auditors presented the letter of engagement and audit plan, described the audit process and proposed the fee. The FAM saw a draft engagement letter before it was provided to the Audit Committee so he could review it for changes since the previous year. The FAM stressed that the board took all decisions related to fees and that the MC had no authority to make such decisions.

22. Variation in audit fees was driven by cost inflation and market forces, changes in legislation and changes in the investment strategies of the company being audited, for example an increased use of derivatives, or any other factors which the auditors thought increased the complexity of reporting, the level of risk and the amount of audit work they needed to perform. The FAM thought the risk to the auditors fell into two categories: first, generic risk caused by statutory and regulatory responsibilities, for example case law that had found an audit firm liable for damages; and secondly, factors that affected the risk profile of the company being audited, for example switching from investing in listed equities to products that were harder to value, such as unlisted investments and private equity.

Quality

23. The FAM thought the current auditor did a good job on the audit, rating its service level highly. Areas for improvement could be the speed of work and the quality of assistance in proofreading the Annual Report.

24. The FAM thought the audit was relatively straightforward because the auditors could obtain 100 per cent confirmation of the existence and ownership of the investments and cash from the Independent Custodian. The value of the investments could be 100 per cent checked to an independent pricing source such as Bloomberg. The remaining scope of the audit was mainly checking the income received and expenses paid. The Audit Committee received an overview of the whole audit process and the auditors would provide more details when requested to.

25. The FAM thought the key factors that made a good audit firm were the quality and approachability of the AEP and for the company to feel that it was an important client

to the firm. For the audit itself, the FAM highlighted the quality of the audit team, in particular the continuity of personnel, efficient service delivery (for instance, avoiding repetition of questions from different members of the audit team) and raising issues early on in the audit process. This was important given the necessarily tight reporting timetable.

26. The FAM thought that the level of advice provided was important. He looked to the auditor to advise the company on changes in applicable law and regulation and, in particular, changes to the tax regime that would affect the tax position of the company.

27. From previous experience, the FAM thought continuity helped to build relationships. He noted that in another business (not an investment trust) he had experienced auditors who were not commercially aware and who focused unnecessarily on small amounts. He thought that in some cases this was due to the personality of the individual auditor.

28. There had been no issues of restatements at the company save for where changes in Generally Accepted Accounting Practice required the restatement of prior year figures.

29. The companies that the FAM worked on were in the process of AEP rotation. He said that this had not affected the audits as, although the AEP had changed, the new AEP was experienced and the audit team was essentially the same. There had been no discernible change in audit quality.

Reputation

30. The FAM had experienced no external pressure to switch to a Big 4 auditor: the current auditor, though smaller, had a good presence in the investment trust sector. He presumed that this was one of the reasons why it was chosen as auditor.

Non-audit work

31. The company did not routinely use its auditors for non-audit work. Tax services were largely provided by the MC, who used a Big 4 audit firm [✄] to provide tax advice. However, occasionally the auditor might provide some non-audit services [✄]. (The FAM commented that the most common non-audit service for auditors to provide was tax advice.)

The Audit Committee Chair’s view

32. The ACC [✄] joined the board [✄] following the decision to appoint [✄] the current auditor and became ACC in May 2010. The ACC was a Chartered Accountant. Having trained at KPMG, in 1980 he moved into broking and a career in fund management. He was ACC of two other investment trusts which used a mixture of Big 4 and mid-tier audit firms. He was also Chairman of one other investment trust and a director of another.

Relationships with stakeholders

Auditors

33. The audit of an investment trust was relatively straightforward compared with many FTSE 350 businesses. This was reflected in the size of the company's audit fee (approximately £[✂]).

34. The ACC met with the AEP as often as necessary. Typically this was twice a year. These meetings occurred:

    (a) in October when the AEP presented the plan for that year's audit (year end 31 December); and

    (b) in late February when the AEP presented the audit report at the Audit Committee meeting. This meeting took up to 1½ hours and the Audit Committee would review the accounts and approve or suggest changes. The ACC would also have a discussion with the AEP shortly after the audit work had taken place, and in advance of the Audit Committee meeting.

Management

35. The ACC saw the board's responsibility to be to set the accounting policies and to state if the company was a going concern. He noted that a number of investment trusts had continuation votes every few years (in the company's case every two years) where the shareholders had to vote in favour of continuing with the investment trust. If they did not, the company would potentially be wound up.

36. As noted, the MC provided the management services for the company and its accounting/finance department prepared the accounts. The ACC said that there was considerable contact with the MC as they organized all the company's board meetings and supplied the Company Secretary.

Shareholders

37. Last year, the Chairman and ACC held meetings with seven of the largest shareholders after the publication of the Annual Report. The Chairman had a further meeting where he was accompanied by the Company Secretary. This was primarily as the company's shares were trading at a sizeable discount to net asset value. The Chairman offered shareholders the chance to meet each year after the final results were announced. Some similar meetings would be held this year. The board was keen to interact with shareholders.

38. At the AGM, the appointment or reappointment of auditors had been uncontroversial and had always been voted through.

39. According to the ACC, shareholders on the whole did not take much interest in auditor selection. He had seldom heard it queried. They might be more concerned and seek a change in auditor if there was some corporate scandal along the lines of Enron. With regard to the company, auditor selection tended to go through without challenge.

Resolution of audit issues

40. There were generally very few issues which needed to be resolved. Issues that had been discussed tended to relate to changes in accounting policy or tax treatment for investment trusts. The ACC expected the auditors to provide challenge and raise issues if there were any.

41. The ACC role was time-consuming. The Annual Report was detailed and could not be reviewed by a logic check: a detailed review was necessary. The non-executive directors needed sufficient experience to be able to ask challenging questions on behalf of the shareholders. The ACC explained that three of the current board members had direct investment experience while the other two came from different backgrounds. He thought that the board had the expertise and experience necessary to ask the right questions on behalf of shareholders.

42. An investment trust ACC was generally paid around 10 per cent more than the other non-executive directors (who did not have the same level of responsibility), but less than the Chairman.

Switching auditors

Switch from previous auditor to current auditor

43. The ACC was not in position at the time of the selection of the current auditor but he was able to explain the background to the decision following review of the Audit Committee and board minutes. The change of auditor followed a series of problems with the previous auditor. These included technical errors, communication issues, and generally poor levels of service. For example, issues had been raised at the Audit Committee meetings without being flagged to management first; the previous auditor had listed requests as outstanding when management had already provided the information; the audit team did not know the names of some of the management team despite working with them for several years. The ACC was not aware of the detail of the technical issues. While the concerns were not very significant, they had persisted despite having previously been raised with the previous auditor.

44. There was also a feeling that the previous auditor was an enormous firm and that the audit fee for investment trust businesses such as the company was not that attractive to it. However, auditing a FTSE 350 business had public relations benefits for the previous auditor.

45. At the time, a number of the MC's branded/managed investment trusts used the previous auditor and a decision was taken by the boards to hold a formal tender process, with the ACCs from each investment trust forming the panel. The MC considered that if the MC's branded/managed investment trusts moved in step to look at auditor reappointment, they could exert more buyer power (for example, the previous auditor might not mind losing one client but to lose, say, three would be more serious). The decision to recommend auditors to the shareholders remained with the board of each company individually.[1]

46. Three audit firms tendered for the work: the current and previous auditors and another Big 4 audit firm [✂]. The panel decided that the choice was between the

[1] Not all the MC's managed trusts did use previous auditors. One trust was audited by another Big 4 audit firm [✂]. There were no issues with this audit firm and so this trust did not participate in the tender process. All the other trusts switched auditor at the same time.

previous incumbent auditor and the current auditor. The ACC was not aware why the other Big 4 audit firm was not favoured. Given the issues that had occurred with the previous auditor, the current auditor was selected. It was felt that the current auditor had an enthusiastic and well-focused team, had good communication skills and had presented well to the panel. The decision was unanimous. The board proposed it as auditor to the shareholders, based on the Audit Committee's recommendation.

47. The ACC told us that his personal view, and one he suspected was shared by the board at that time, was that the current auditor was more proactive than the previous auditor in this sector. Investment trust businesses were a specialism for it and it had a good understanding and good reputation in this industry.

48. The ACC's view was that the fifth and sixth largest firms in the market needed to differentiate themselves (by way of developing expertise and experience in specific sectors) in order to get a foothold in the FTSE 350 audit market. Trying to replicate the four largest firms was unlikely to be an effective competitive strategy.

Awareness of other options

49. The ACC had not received any unsolicited bids for the company's audit. He received correspondence from the previous auditor and other audit firms in relation to non-executive director courses, dinners etc, although did not attend many.

Fees

50. The agreed audit fee was £[✂], but given some communication issues (see paragraph 51) this was reduced to £[✂] for one year. This had increased from around £[✂] when the current auditor first took on the audit and reflected inflationary changes. If a fee proposal contained a 3 to 5 per cent increase, the ACC would probably accept it. If there was a 10 per cent proposed increase he would resist and require a good rationale for accepting it. He said that he would lead on fee negotiations and if the proposed increase was controversial then he would consult the whole Audit Committee.

Quality

51. There had been some issues with communications, but these had now been resolved. [✂]

52. The AEP [✂] had rotated this year (and so the new AEP [✂] had completed the 2011 audit). The ACC was happy with both individuals and felt that partner rotation was a good opportunity for a fresh set of eyes on the accounts. He considered that both the AEPs were strong in the investment trust sector and that it would be difficult to find better.

53. The draft accounts that the Audit Committee received this year (2011) from the MC were not as accurate as they usually were. The Audit Committee had picked up around 30 points that needed discussion (compared with the usual half a dozen). A process was under way to assess why this had happened. It seemed likely that the management team at the MC had not had sufficient time to prepare them but there had also been issues with the typesetters.

54. The ACC noted that the Financial Reporting Council had sent him the Audit Inspection Unit (AIU) report into the current auditor and that he had been a little disappointed with the results as two out of ten audits reviewed had been flagged as

requiring significant improvement. He had raised this with the AEP in writing on behalf of the Audit Committee. These issues did not relate to investment trust audits but were still of concern to the ACC. The current auditor had undertaken to improve.

55. In considering audit quality, the ACC thought that measures included service levels, the quality of reports produced, technical expertise, as well as reports from the AIU. He said that he liked to feel that the auditors 'had had a good look around' and to ensure that they had looked at large enough sample sizes. 'It is important that they do actually get down to it, and actually look at the transactions.' He also expected the auditors to focus on particular areas each year, for example when the company had started using Contracts for Difference (CFDs) to finance the business and the auditor had focused on these.

56. The ACC thought there were continuity benefits in having a long-term relationship with the auditor due to the auditor knowing the business well, who to ask, which areas to focus on etc. This improved efficiency as 'there was always an element of getting to know the client before you can actually get down to the detailed audit'. He considered that after a while there was a risk that the auditor would stop challenging management so effectively. The ACC felt that a balance needed to be struck between an auditor auditing a company for too long and auditing a company for a sufficient length of time to benefit from continuity. He thought that partner rotation every five years dealt with this risk to a large extent.

Reputation

57. There had been no issues regarding the company using a mid-tier firm rather than a Big 4 firm. The ACC thought that the current auditor was a large and well-recognized firm, particularly in the UK outside London.

58. The ACC did not consider that there was any issue in agreeing financing arrangements when a company had a non-Big 4 auditor. The company would not have accepted the current auditor if there was a financial implication to this.

Non-audit work

59. The company did not regularly use its auditor for non-audit work other than a review of performance fee adjustment calculations. Tax services were largely provided by the MC. If there was ad-hoc work, then the auditor could be used if the work was small and independent of the audit. If there was a large piece of work, the ACC felt this might be better done by someone other than the audit firm.

The AEP's view

60. The AEP [✂] led the successful tender for the current auditor in [✂]. He had recently rotated off the company audit. He started his training in 1992 with a small practice in London and moved to a Big 4 firm for his final year of qualifying. The AEP was with a Big 4 firm [✂] for nine years working as a senior manager on large bank audits. He then moved to the current auditor as partner designate.

61. At the current auditor, the AEP specialized in the audit of investment funds and companies and currently he audited approximately 20 other listed investment companies. Two of these were FTSE 350 companies.

62. The AEP moved to the current auditor as he preferred to work with smaller clients where he could get a good overall knowledge of the client's business. From his time

at the Big 4 auditor, the AEP observed that partners tended to have only one or two large clients.

Relationships with stakeholders

Management

63. The AEP was the lead partner for four of the MC's branded/managed investment trust audits [✄]. His main interaction was with the staff at the MC who ran the investments and with the accounting team (the FAM). The AEP spoke with the MC to understand commercial issues concerning the company to understand the context in which the company operated.

Audit Committee

64. The main document the auditors prepared for the Audit Committee was the key issues document which outlined the critical audit areas and the areas where there was less risk, but still constituted a significant part of the balance sheet and hence the audit work conducted.

65. The auditors' work was visible to the Audit Committee to an extent through the audit plan. This was agreed each year, and was provided to the Audit Committee before the audit started so that the Audit Committee had time to consider, think about and debate the plan.

66. The extent of work undertaken by the auditor was also discussed to an extent in negotiating the fee, for example justifying areas which needed extra work. The Audit Committee did not get involved in audit testing but had an understanding of the audit strategy and the process.

Shareholders

67. The AEP had no interaction with shareholders.

Resolution of audit issues

68. The AEP thought that the Audit Committee was reasonably well placed to identify issues that were not addressed by the auditor as well as challenge areas that the auditors had addressed, but the business was relatively simple. Bank debt and the use of derivatives gave the company a particular risk profile but the Audit Committee was given information on the performance of, and the strategy relating to, these positions throughout the year.

69. The only issues that arose were communication issues (see paragraph 51) rather than contentious accounting issues.

Switching to the current auditor

70. Prior to the tender, the current auditor had a good presence in the investment company sector. It ran training courses for the Association of Investment Companies (AIC) on audit and accounting matters for non-executive directors of investment companies. It also built its profile with investment houses through publishing technical updates on accounting and taxation matters and running other courses. Two of the MC's directors attended the AIC courses, allowing the AEP to speak to them. The

AEP thought the effort made in building the firm's profile was the reason why the current auditor was considered when the company decided to tender.

71. As noted in paragraph 60, the AEP led the tender process for the current auditor in [✂]. Before submitting a proposal, the AEP spoke to the company secretarial staff about the nature of the company and the service required. There were no meetings with the Audit Committee before the pitch meeting. A lot of work went into the pitch from the current auditor, as the MC was a well-recognized brand and two of the investment trusts being tendered were considered high profile.

72. The AEP attended a selection panel which consisted of the MC's accounting and secretarial staff, three ACCs (from the different investment trusts) and another director from the four investment trusts up for tender.

73. The AEP thought there were three reasons why the current auditor was successful in the tender: [✂].

Annual reappointment

74. The current auditor's performance was reviewed annually as part of the standard Audit Committee agenda. Performance was debated at the Audit Committee with feedback from management. The AEP had not been required to repitch for the work.

Fees

75. The fee was negotiated with the Audit Committee. The fee was initially proposed as part of the pitch and was agreed with the Audit Committee after appointment. The AEP said that deriving the fee was a 'bottom up budgeting exercise', estimating the anticipated number of hours and staff required to conduct the audit. The fee was fixed for the second year of the audit to give some certainty to the Audit Committee that the fee would not be increased sharply after the first year.

76. There was an additional cost in the first year of the audit associated with setting up the audit process and learning about the business. Recovery rates improved as knowledge of the company increased.

77. During the AEP's tenure the requirements for the audit increased, and he proposed fee increases to the four unit trust Audit Committees for which he was responsible. Three of the Audit Committees accepted the increase, acknowledging that more work had to be done. The other Audit Committee refused the increase, resulting in the larger audit being conducted for the original fee. The AEP was not concerned that the relatively lower fee would have implications on the quality of the audit—simply less money would be made on that audit.

78. The AEP had experienced the threat of tendering as a way of lowering fees on other audits but not in the case of the company. The AEP thought that the Audit Committee was always reasonable and receptive to having a discussion about fees, and as such pressure on fees did not compromise the quality of the audit.

Quality

79. The most important aspect of quality for the AEP was ensuring that the opinion was right and ensuring that the Annual Report met accounting standards. To do this, the auditors must have undertaken a risk assessment, understood the control environ-

ment and looked at transactions. It was necessary to obtain the appropriate level of audit evidence over each of the assertions, transactions and balances.

80. This Audit Committee in particular wanted to understand whether they were complying with best practice in terms of the Annual Report, and this was an area on which the auditors could advise.

81. A new AEP was introduced in the final year of the AEP's tenure. The new AEP was introduced to the MC and had the opportunity to meet the board members of each investment trust. He also attended a meeting with all the ACCs to discuss his experience. The ACCs' main concern was the communication of risks. The AEP was not aware of any changes being made to the audit approach by the new AEP.

82. The AEP did not think that the quality of the audit had changed particularly over time, due to the relatively simple nature of the audit. He had experience of auditing a large bank ([✂]) (when at a Big 4 auditor) which was a lot more complex and took a lot of time to get familiar with, a process which could be 'painful'. In contrast, the AEP said that all investment houses were broadly similar, and at the time of winning the company's audit he was already doing a lot of similar audits, therefore there was not as much extra work required.

83. The AIU reviewed the company audit in [✂]. The audit was found to be satisfactory with no areas requiring improvement. The AEP had shared the AIU's letter style report with the Audit Committee and discussed the findings with it so that they were content with the findings and the rating. There had been no referrals to the Financial Reporting Review Panel during the AEP's tenure.

84. Auditor professional liability was a concern and was something he was conscious of, particularly in relation to the audits of big companies. He thought this risk was addressed in the audit approach. The biggest risks the company posed were the ownership of the assets and that the assets were being used for something they should not have been. The AEP was very conscious that if the audit firm failed to spot something here, the firm would be in a lot of trouble: 'You only need to make a mistake once and the firm could go down'.

Non-audit work

85. The current auditor had not performed any non-audit-related services for the company. In another MC-branded investment trust, [✂], the company had been the reporting accountant for an initial public offering.

86. The AEP thought there were some services where it would be more cost effective to use the auditor. These services were where an understanding of the systems and controls of the business were needed, for example tax compliance, tax advice and client money reports to the Financial Services Authority.