STATUTORY AUDIT SERVICES MARKET INVESTIGATION

[Company I]

Background

1. [Company I] (the company) was a FTSE 250 [✂] business with international operations (primarily in Europe). The company had revenue of [✂].

2. The company had a range of institutional investors, mainly based in the UK. [✂]

3. The company had had the same auditor, one of the Big 4 firms [✂], for over 20 years and had not recently tendered the statutory audit. Following service issues, changes of partners had occurred twice in the last few years. The audit fee was in the range of under £2 million (£[✂] million).

The Group Finance Director's view

4. The Group FD was a qualified accountant with a wide range of experience in industry and while at the company the FD had only experienced working with the current auditors. However, during previous roles he had worked with other auditors, including from the Big 4 firms. (The FD had no other non-executive roles). [✂]

Relationships

Audit Engagement Partner

5. The FD had very frequent contact with the senior AEP during the year, approximately every two weeks. This was most frequent during the interim and final audit processes. The FD's key contacts were two partners at Group level in the UK. Another member of the Finance team was the main contact with the lead partners in overseas territories. The FD only had contact once or twice a year with these partners.

6. The FD was pretty close to the auditors in terms of knowing what work they were doing. The closest relationship was between the auditor and the other senior members of the Group finance team [✂]. They were responsible for the day-to-day running of the audit process, including involvement in the planning process, dealing with overseas management and collecting all audit issues. Only the more material issues were discussed with the FD.

7. The audit team produced the initial audit plan. This was subject to review by the finance team before going to the FD. The plan was then presented to the Audit Committee which was responsible for a final review and the final decision on the audit plan. This process was at the Group level. There was also work between local finance teams and local partners in subsidiary territories.

8. The company used the same auditor for all its subsidiaries where a statutory audit was required. The FD thought that this had positive aspects from a coordination and communication point of view. The FD thought that the process was generally much easier with only one auditor, but this would not stop the FD changing a particular subsidiary's auditor if there was a serious issue.

Audit Committee

9. The FD met the ACC at Audit Committee meetings and at the other board meetings throughout the year. He also had informal interactions with the ACC, particularly if there were significant material issues or significant judgements to be discussed before Audit Committee meetings.

10. When the ACC changed a role specification was produced by the nomination committee with a focus on a candidate with significant financial experience, given the financial experience necessary to be an ACC.

Shareholders

11. The FD had considerable interaction with shareholders generally, but the topic of auditor was not raised directly with him. There had been questions about particular accounting issues, but not the choice of auditor. There might have been a question directed to the ACC at the AGM about whether appropriate considerations had been given to the reappointment of the auditor.

Resolution of audit issues

12. There had been no significant disagreements over accounting treatments, but there were serious discussions on judgement matters which in the FD's opinion were to be expected. The FD characterized this as a healthy level of debate between both the company and the auditor and within the company between the FD and ACC.

13. Some of the areas which caused most discussion between the FD and the AEP included [✂].

14. Ultimately it was the Audit Committee's role to take a view on any issues, and if the auditor disagreed with a view it would have to state and document its disagreement. The finance team's role was to ensure that where issues arose, all relevant facts and details were obtained so the necessary information was available to the auditors, the Audit Committee and the FD for a proper discussion.

15. The process for resolving issues depended on the scale of the specific issue. Issues arising at a local level would be discussed between the local audit team and local management. Depending on the scale, this might go up through the company to the Group FD and Group AEP and finally up to the Audit Committee and ACC.

Auditor selection

Annual reappointment

16. The auditor had audited the company for over 20 years. Each year there was some debate at Audit Committee meetings before making a decision to reappoint. In the last few years, the subject of tendering had been debated more seriously, but the company had been focused on other strategic priorities and a decision had been taken not to tender at the current time. There were no current plans to tender.

17. The company conducted an annual assessment of the auditor's performance. The criteria against which the auditor was assessed included:

    (a) independence and objectivity;

(b) the members of the audit team;

(c) technical skills; and

(d) service levels and fees.

18. Debates at Audit Committee meetings focused on whether the company was receiving the right quality of service, whether the fee was competitive and whether the company's other strategic priorities enabled it to undertake a tender of the audit service. There had been a couple of issues concerning the auditor's performance and the company debated whether the auditor had made the necessary commitments to change and whether it had subsequently demonstrated change.

Switching the Audit Engagement Partner

19. The company had not switched audit firm but the audit firm chose to change the AEP in light of certain performance issues. Recently in [✂] the company thought that the auditor had not thoroughly investigated an issue that eventually came to light. There were also disagreements between the local partner and the Group partner.

20. A few years ago the AEP was changed. This had occurred following concerns about certain decisions being made late and decisions being changed late in the day [✂] (see paragraph 46).

21. The new partner made it clear to the company that it was recognized that the auditor was on notice. The company needed to have timely decisions made which were not subject to change—something the FD thought was understood by the new audit team. The company continued to use the auditor as it thought that the auditor performance at the Group level had improved.

Switching costs

22. The biggest cost to a company of holding a tender was the time cost, particularly for the finance function. There was a substantial amount of time needed to meet all the key operational executives and to get to know the business. The company had experienced these costs to an extent when audit partners had changed, and although it was not as dramatic a change as changing the whole audit team, the FD thought that changing a partner was not a trivial exercise.

Awareness of other options

23. The FD would have to undertake considerable research of potential bidders if the decision were made to tender. He expected that the current auditor would be given a chance to re-pitch as well as other Big 4 firms. The FD would look at mid-tier firms too. The FD stressed that it was not about the audit firm as much as it was about the capability of the individual partner.

24. The company had never come under pressure to change auditor. The company's banking agreement with its lender banks did include provisions which required bank approval to a change of auditor if one of the Big 4 was not used. The banks could not unreasonably withhold or delay approval.[1]

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[1] [✂]

25. The company had not overtly received approaches from other firms regarding the audit. The FD and other team members had worked with other audit firms on various matters. These were primarily Big 4 firms [✂], although some smaller pieces of work had been undertaken by a mid-tier firm [✂]. The FD had not been approached by mid-tier firms.

Fees

26. Audit fees were preliminarily discussed at the subsidiary level. These fees were reviewed and challenged at the Group level before being submitted to the Audit Committee. The company benchmarked against similar companies, mainly in the same sector, which formed part of the regular Audit Committee papers when reviewing the fee each year.

27. Variation in fees was caused by changes in scope either due to changes in regulations in different territories or any transactions the company had completed during the year. The FD wanted to understand where the audit hours were being spent and to make sure that the number of hours was appropriate. For example, if a particular control issue needed a lot of time in one year the FD would not expect the same number of hours to be spent on the issue in subsequent years.

28. The audit scope was largely fixed. However, for its own reassurance, the company had employed another Big 4 audit firm [✂] to undertake work on a small overseas subsidiary which did not require auditing for statutory purposes. The additional auditor was chosen as the local FD had an existing contact, the company wanted an independent look, and wanted to try that audit firm. The company did not feel tied to its existing auditor, or that the work had to happen during the main audit timetable.

Quality

29. The most important aspects of quality from the FD’s perspective were those reviewed annually (see paragraph 17). It was not in the interest of the FD to compromise the levels of service by reducing fees. From his perspective, it was about obtaining good value which was a combination of service and price.

30. In terms of value added, the FD thought that the audit provided an assessment of the depth and quality of the company controls. The FD also valued the management letter provided by the auditor. He found this helpful as it was always useful for someone who understood the business and had an external perspective to provide extra views.

31. The FD thought that the AEP was crucial in the provision of the service and therefore changing partner could have an impact on the quality of an audit. Changing partner was not a trivial exercise, but in the company’s case it had been felt to be necessary and subsequently the company received much better levels of service. At the time of partner changes, the auditor proposed a group of candidates for the company to interview and from which to select.

32. The Audit Inspection Unit (AIU) reviewed the auditor in connection with the company audit. Shortly after the conclusion of the AIU review, the company received a letter from the Financial Reporting Review Panel (FRRP). [✂]

33. The AIU reviews focused mainly on the way in which the auditor documented how it reached conclusions. The AIU report did not lead the company to question the use of the auditor. In respect of the exchange with the FRRP, this resulted in certain

disclosure enhancements. The FD welcomed any opportunity for value to be added to what was disclosed.

Non-audit work

34. The company's policy was not to use the auditor for non-audit services. The FD thought that auditors should audit and other firms should do other work. This was an Audit Committee policy which was kept under review. Any fee for non-audit work which was greater than £[✂] had to be approved by the ACC.

35. The company used certain of the Big 4 firms for tax [✂] and internal audit work [✂]. In the last 12 months there were no non-audit contracts which had greater value than the audit fee, although this might not always be the case.

The Audit Committee Chair's view

36. The company's ACC [✂] was a qualified accountant and had been a non-executive director and ACC for a number of years. He had a wide range of experience working in finance positions both in industry and in his early career at audit firms (both mid-sized and Big 4), [✂]. He also had experience of dealing with the Big 4 as either auditors or consultants in his roles at the company and elsewhere. [✂]

Relationships

Auditors

37. The ACC would meet with the auditors on a regular basis at Audit Committee meetings (usually held four times a year) and at one-to-one meetings with the AEP to discuss issues to be raised at the Audit Committee. He also met the AEP once or twice a year informally for a general catch up.

38. The ACC had never asked the auditors to do less work or to do more work than was required by their statutory responsibilities. He tended to emphasize particular risks if he thought they were more important for the audit, for example if there were new businesses to be audited.

39. The ACC had quite a lot of detail of the auditors' work. He saw the audit plan which was reviewed and discussed with the Audit Committee. He also received comprehensive reports of the extent and scope of their work.

Management

40. The ACC met the FD at the Audit Committee meetings and board meetings. He spent time with the FD before all of these meetings to talk through the issues. He spoke relatively frequently with the FD about issues that concerned him (very few of which related to the audit). During his tenure, the ACC had worked with a number of different FDs. He viewed part of his role as ACC to 'mentor' them, which meant spending more time with the FDs particularly in the early parts of their tenure.

Shareholders

41. The ACC was the Senior Independent Director (SID) and had met shareholders as part of this role, but the auditors were not discussed.

Resolution of audit issues

42. There had been no significant disagreements with management over any accounting treatments. There had also been no significant disagreements with the auditors. There were areas of judgement that were robustly debated each year, but all debates reached a sensible conclusion.

43. Audit Committee meetings tended to last two to three hours. The ACC spent a similar amount of time preparing for the meetings and reading the documentation.

44. The main factors that influenced the ACC's performance were personal integrity and professional reputation, and following appropriate corporate governance practices. He reported to the Chairman but did not feel the Chairman was looking over his shoulder. The ACC had a communication responsibility to shareholders in his role as SID.

Auditor selection

Annual reappointment

45. The reappointment of the auditors was discussed at the Audit Committee meetings and the ACC was very involved. There was a formal review of the auditors' performance conducted annually (see paragraph 17). A number of areas were reviewed including the responsiveness of the audit team, timeliness of reporting, thoroughness and completeness of approach, value added from the management letter, competence of the partners, the quality of international offices and aspects of governance (such as independence and objectivity).

Switching the AEP

46. The ACC described a situation when the company was dissatisfied with the auditor's performance, particularly as it occurred during a busy period for the company [✄]. The company felt that the auditor was inconsistent with its approach to certain issues [✄] and late in coming to a final decision. Although this did not cause a problem, it could have done.

47. For the above reasons, the company was not happy with the performance of the AEP [✄]. Consequently the audit firm chose to replace the AEP. The company interviewed the prospective AEP [✄] and also had discussions with the auditor in order to improve communication, particularly around areas of judgement and prevent any further issues. Since the change in team members, the ACC thought that there had been significant improvements in the auditor's performance.

48. There had been a substantial increase in the number of partner hours on the audit (see paragraph 79). The ACC thought that this could be attributed to an additional partner being added to the audit team in response to the company's concerns about the quality and experience of the previous AEP. It was also partially attributable to the 'learning curve' that the new partners had to follow to understand the business. There was a concern from the ACC that the AEP might not devote enough time to the audit given the AEP's management responsibility (see paragraph 63), but he suspected that the AEP was willing to 'go the extra mile' to address this concern.

Switching costs and tender triggers

49. The auditor continued to be used principally because the ACC thought that the company now had a higher-quality audit team. The ACC highlighted that the current AEP was a better communicator and better at delivering on time. An important factor in deciding whether to switch auditors was the management time required to conduct the tender and the time needed for the new auditors to get up to speed. The ACC highlighted the distraction and disruption to management as a general cost of switching auditor. The issues with the auditor had occurred at a time when management needed to be focused on other strategic priorities.

50. The ACC thought that tendering would be looked at again in the near future. It was felt important that the company should feel it was able to devote the necessary time to both the tender process and bringing the audit team up to speed following a change. At the current time, the reasons why a tender would be held would be for reasons of good governance. The ACC stated that a tender would have been held if the auditor team led by the new partners had not stepped up to the plate.

Awareness of other options

51. The ACC thought that the company was limited in the number of firms that could perform the audit as it was a large and complex business with a number of overseas subsidiaries. There were a number of firms which did not have the international presence, which would make it difficult to perform the audit properly.

52. The ACC also thought that the reputation of the auditor was important for the City and other stakeholders, such as debt providers. Lender approval would be needed to use an auditor outside one of the Big 4 firms. The ACC thought that Grant Thornton and BDO would be the next best auditors after the Big 4 firms. The ACC had worked with all the Big 4 firms and was clear about their capabilities but was less clear about the strengths of the mid-tier firms. He would look to understand this better in the event of a tender.

53. The ACC had not been approached by other firms in relation to the audit, but had interaction with other Big 4 firms in his other current and previous roles and through other consultancy work. His interaction with other firms mainly came from invitations to seminars on technical subjects.

Fee

54. The company had a bottom-up approach to the audit fee. Individual fees were agreed at local subsidiaries before the Group finance team would take a view on the fees. The overall fee came to the Audit Committee for review. It was presented with a justification for the fee and benchmarking of the fee.

55. Benchmarking included a combination of experience, looking at the charge-out rates and the number of hours, and making comparisons against other companies based on the publically available information on audit fees, taking account of market capitalization and perceived complexity. This allowed the company to see if the audit fee was in line with the market. The ACC added that benchmarking was not an exact science.

56. The fee was negotiated on an annual basis but had not changed significantly in the last few years.

Quality

57. The ACC looked for the quality of the auditors’ reports to the Audit Committee in terms of how it was presented and the quality of documentation behind it. This included understanding the scope of the work, the assessment of the control environment, recommendations from the management letter and the calibre of individuals.

58. Assessing whether the auditor had made mistakes came from understanding the scope of the work, the level of materiality being worked to and understanding the ways in which the auditors formed judgements. The ACC thought that management and the Audit Committee viewed quality in the same way—where they had been frustrated they had been jointly frustrated.

59. The ACC did not think that reviews by the FRRP were helpful in assessing overall audit quality. The review of the company had focused on disclosure, and while it might have been helpful in leading to better disclosure the ACC was not sure that it indicated quality. The review could have pointed out quality issues but did not.

60. The ACC thought that every time there was a rotation of the partner there was an increase in the time required getting up to speed, but the auditor managed this well. The ACC thought that different partners did bring different experience and had different styles, but his impression was that although each individual had certain ‘bugbears’, the judgements and the approach to risks were largely based on the auditor’s firm’s approach .

61. Any value added the audit brought came through the management letter on improvements to the processes within the business. The quality came from how insightful and relevant these observations were. The ACC did not think there was any other added value.

Non-audit services

62. The company worked from a presumption not to use the auditor for non-audit work for reasons of good governance and independence of the auditor. There were exceptions where other regulation required the auditor to perform the work. There were also cases when it was considered appropriate to use the auditor due to its knowledge and competence, or there was a strong historical reason and it would not make commercial sense to switch. It was pretty rare for this to happen.

The AEP’s view

63. The lead AEP [✂] was an experienced partner and audited a number of listed companies [✂]. The AEP had held management positions within the audit firm.

64. The supporting partner also had a portfolio of listed clients. [✂] Both the AEP and supporting partner had trained with the auditor (or its predecessor firms).

Relationships

Management

65. The company [✂] had a number of significant judgements to be made which required a lot of interaction with management, particularly the CEO and FD. There

was also a regular dialogue with the Chairman and the ACC. The AEP communicated with the FD every other week and saw the Chairman every two months.

66. There were three intense audit periods during the year when the AEP would meet management more frequently. The first period was for interim reporting in [✄ *month*], followed by an ‘early warning review’ in [✄ *month*] with the final year-end reporting in [✄ *month*]. While preparing for the early warning review, the AEP spoke to the FD two or three times per week.

67. The AEP and supporting partner had extensive interaction with local management in the key overseas jurisdictions. A lot of time was spent overseas to understand issues first hand. The AEP thought that this was important from a quality and client service perspective.

68. The AEP had known the FD for broadly 2.5 years as the FD had had a number of roles within the company prior to being appointed FD, in relation to which the AEP had worked with him. The ACC asked the AEP to spend time with the FD to help induct him into the role. The AEP saw the FD as very measured, open and commercial. The FD had been with the company for a long time and had a very good understanding of the business.

Audit Committee

69. There were usually four Audit Committee meetings during the year which were always attended by the Chairman and CEO. The AEP formally met the ACC before each of these meetings and ‘as and when’ on other occasions. The annual timetable for Audit Committee meetings was:

   (a) [✄ *month*]—audit plan;

   (b) [✄ *month*]—interim reporting;

   (c) [✄ *month*]—early warning exercise; and

   (d) [✄ *month*]—final reporting.

70. The AEP also had a role inducting new members of the Audit Committee into the role. [✄] .

Shareholders

71. The AEP had no significant interaction with shareholders and shareholders had not expressed a wish to meet the auditors.

Resolution of audit issues

72. The audit plan was scoped with management prior to presentation to the Audit Committee in the second quarter (see paragraph 65). The audit was initially scoped between local audit teams and local management for each subsidiary, then consolidated into an overall plan for the group. At this stage management consulted with the ACC but the AEP would not discuss issues in this initial scoping stage with the ACC. However, the AEP discussed the scope and the full plan prior to the Audit Committee meeting at which the plan was approved. Given the scoping work that had already taken place and the dialogue between management and the Audit Committee and between the AEP and the ACC, the audit plan would usually be

accepted as it was presented to the Audit Committee—any changes tended to arise due to changes in the business after the planning stage.

73. The most complex accounting issue related to [✂].

74. The Audit Committee received a thorough paper from the auditors that detailed where they had been and what they had found. The year-end audit paper was approximately 40 pages long and covered the accounting judgements and the work the auditors performed. The Audit Committee also received papers from management on each accounting issue.

Auditor selection

Annual reappointment

75. The auditor went through an extensive evaluation process with the company each year. The company's internal audit function created a questionnaire which was issued to management in each of the audited territories. The results were presented at the first Audit Committee meeting of the audit cycle in [✂].

76. The main areas of performance that were reviewed were: independence and objectivity, quality and experience of the audit team, technical skills, visibility of key partners, service levels, fees and overall value of the audit, communication with the Audit Committee and the overall audit approach. No major issues had been raised as a result of the annual review during the AEP's tenure.

Switching the AEP

77. When the AEP started working on the company audit there were various challenges in the [✂]. The company [✂] considered that the auditor was slower than the company would have expected in getting to the bottom of certain issues and resolving them quickly.

78. The AEP believed that the CEO would have been happy to change the auditor at the time, but the ACC was worried about the stress on the business and the timing of such a switch, given [✂].

79. For a number of reasons (the need to ensure that the relationship was restored to a sound footing, the new audit partners, and the increasing complexity of the audit [✂]), the auditor agreed to increase the level of contact with the company and total partner hours. The AEP said that it was important that before exercising any judgements they were seen to have 'all their ducks in a row' and that essentially there were no surprises for the company. This saw the number of hours partners spent on the case increase from 380 in 2009 to over 600 in 2010 and over 1,000 in 2011.

80. The number of audit judgements had increased in recent years, thereby increasing the complexity of the audit. The increased complexity of the audit in some subsidiary countries was one reason why a second partner was added to the audit team. The increased number of partner hours in 2011 reflected this.

Fee

81. The discussion of fees was first held between management and the audit team in each separate territory that required an audit. The scope of the audit depended on the number of statutory entities that needed an audit and the detail of reporting

required. This was an extensive process given the complexities described above. The Group fee was initially negotiated with a senior member of the finance team who reported to the FD.

82. The AEP thought that the company was very tough on fees [✂].

83. The fee had remained fairly constant during the AEP's tenure. Recovery rates had fallen due to the increase in partner hours required for the reasons explained above.

84. The AEP had not received an explicit threat of tendering from the company to put pressure on the audit fee although it was aware that the auditor was under constant scrutiny. The company benchmarked across the [✂] sector to get an idea of what was a fair fee.

85. The AEP did not think that pressure on fee compromised the quality of an audit, and in such circumstances the AEP would not undertake an audit. The AEP thought that the ACC provided a good counterbalance to management with regards to the audit fee and always asked if the fee was sufficient to do the job.

Quality

86. As noted above, the company had had concerns in relation to the auditor's delivery of a non-audit piece of work and timeliness of decision making on key judgements. This led to a change in the AEP. Although no concerns had been expressed in relation to audit quality, the combination of the need to restore the relationship, the change of audit partner and the increasing complexity of the audit led to the number of partner hours on the company audit increasing substantially (see paragraph 79). [✂]

87. During the AEP's tenure there had been no incidences of restatement. There had been one FRP letter during the AEP's tenure. It focused on [✂]. The issues were resolved satisfactorily.

88. The AEP had internal responsibility at the auditor for managing the rotation of partners for all FTSE-listed companies. The AEP would discuss with the ACC and FD what they were looking for in the new partner and would shortlist three candidates to be interviewed. This process happened in the year leading up to rotation—the new partner could act as the supporting partner in this year to get to know the business. The AEP thought this was important, and they saw it as part of their role (with regard to the company and more generally in their management capacity at the auditor) to ensure a 'seamless transition' when audit partners rotated from a relationship and judgement point of view.

89. The auditor had sought to add value by conducting an internal survey for the CEO on [✂]. It also conducted a benchmarking exercise of internal financial controls to compare the quality across jurisdictions and look for areas of improvement.

90. The company audit was a controls-based audit. The auditor had improved the audit of systems and processes and introduced electronic auditing techniques into the audit approach.

Non –audit services

91. The AEP said that the company had a strict policy on non-audit work and, as a starting point, would rather the auditors did not do any non-audit work. Any non-audit fee that was greater than £[✂] had to be approved by the ACC.