Competition Commission first survey results

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Introduction

1. This appendix sets out key results from the CC's first survey, of FDs/CFOs and ACCs of large listed and private companies.

2. This survey was carried out by IFF Research (IFF) on behalf of the CC. Further details on the survey are provided by the IFF technical report and its presentation to the CC.[1] Tabulations of the results have also been published.

3. We have reported results at a company level where the information was factual, for example, when the audit was last tendered. These results are generated using the responses from the FD/CFO where available and responses from the ACC when we did not interview the FD/CFO. Where we asked for opinions or perceptions we generally reported the responses of ACC and FDs/CFOs separately.

4. The structure of this appendix is as follows:

   (a) we describe the data provided by the survey;

   (b) we then set out key results relating to:

   (i) background information gathered on the companies and key results relating to those companies and their audit;

   (ii) the respondents;

   (iii) description of the audit relationship;

   (iv) dimensions of the audit product, including who has most influence in selecting the auditor and the selection criteria;

   (v) market testing;

[1] www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/cc-commissioned-survey.

(vi) tendering—frequency and tender lists;

(vii) switching behaviour and effects;

(viii) triggers for switching;

(ix) formal and informal contact with other firms;

(x) forced diversion;

(xi) reasons for not considering non-Big-4 firms;

(xii) factors limiting choice between Big 4 firms;

(xiii) characteristics of long-tenure and short-tenure companies; and

(xiv) international networks.

5. Our methodology for significance testing is set out in Annex 1. In Annexes 2 and 3 we provide responses in full to questions B17 and C5 respectively.

Description of the data

6. We obtained a total of 607 responses. Table 1 shows the number of responses by company category and the position of the respondent. The overall response rate for the survey, based on the sample frame created for the survey, was 28 per cent. The highest response achieved, nearly 40 per cent, was obtained from both FDs/CFOs and ACCs for FTSE 350 companies. This was likely to be a reflection of both a greater interest in the subject matter and a higher quality of contact information. Further information on response rates can be found in section 2 of the IFF technical report.

TABLE 1 **Number of responses by category of firm and respondent**

	Total number of responses				
Category of firm	*Total*	*FD*	*ACC*	*Pairs**	*Companies*
Sample frame†	2,157	1,044	1,113	1,120	1,120
Total response	607	343	264	133	474
FTSE 100	77	38	39	19	58
FTSE 250	183	95	88	46	137
Listed former FTSE	69	36	33	17	52
Small cap and fledgling	94	51	43	20	74
AIM	73	45	28	15	58
Top Track 100	41	28	13	6	35
Top Track 250	65	47	18	8	57
Former Top Track 100	5	3	2	2	3

Source: IFF survey.

*Pairs: companies for which we had a response from both the FD and ACC.
†The sample frame was the number of records loaded for interviewing purposes, ie those for which details could be found. Response rates were calculated as the achieved sample expressed as a percentage of the sample frame.

7. We considered the response rates achieved to be good for this type of survey. An assessment of the representativeness of the survey is set out below.

8. For all company categories except for AIM a census was undertaken, with an approach made to all FDs/CFOs and ACCs for which details could be found. Though it can be argued that, for a census, standard significance testing does not apply, for the purposes of this survey we were assuming that the responses form a simple random sample from the given populations. As population sizes were small and the number of achieved interviews relatively large, a Finite Population Correction (FPC) factor has been applied to significance tests that have been carried out. This has the effect of increasing the precision of estimates, leading to a narrowing of the confidence intervals.

9. In line with good practice, we reported results only where the base size was 30 or more. Where we comment on how responses of different groups compared (for example, FTSE 350 companies v other companies or FDs/CFOs vs ACCs), all differences reported were statistically significant, and were considered to be meaningful in the context of the inquiry. For clarity, all results that we have tested for

their statistical significance are identified by a '*'. Further details on FPC, confidence intervals, significance testing and minimum cell sizes for analysis can be found in Annex 1 to this appendix and section 6 of IFF's technical report.

10. All survey results reported in this appendix can be extracted from the published tabulations unless marked with '^'.

Background information at a company level

11. For each company, we asked for information on the company, in particular: the identity of the auditor and the services they provided, the audit fee and the proportion of the audit accounted for by non-UK interests; the industrial sector; capital market status over last ten years; and turnover and number of employees.

12. In this section we set out the results found for the survey and, where possible, compared these with known population data provided by the public data set[2] to check the representativeness of the sample achieved.

Audit fee

13. The survey found the following key results:

    (a) The audit fees for FTSE 100 companies who responded to the survey were on average higher than those paid by other companies, for 71* per cent of FTSE 100 companies the audit fee was greater than £1 million compared with 22* per cent for FTSE 250 companies and only 5* per cent for non-FTSE-350 companies. All audit fees above £1 million reported in the survey were for audits carried out by Big 4 firms. The distribution of audit fees found in the survey broadly matched population figures, where available.

[2] The public data set provided population data for 2010 FTSE 350 companies and Top Track 100 companies on industry sector, market shares, turnover and audit fees.

TABLE 2 **Audit fee—survey distribution vs population**

per cent

	FTSE 100		*FTSE250*	
	Population	*Survey*	*Population*	*Survey*
£250,000 or less	2	2	35	30
£251,000 to £500,000	5	7	24	29
£501,000 to £1 million	14	12	20	18
£1 million to £5 million	45	36	20	21
£5 million to £10 million	17	21	0	1
More than £10 million	17	14	1	0
Don't know/not stated	0	9	0	1
	100	100	100	100

Source: Public data set/IFF survey.

(b) The average audit tenure was longer among companies with larger audit fees. For companies with audit tenure of up to five years 11* per cent had an audit fee of more than £1 million. For companies with audit tenure of more than five years 21* per cent had an audit fee of more than £1 million. The difference between these percentages was significant. Again a similar pattern of tenure vs fees was found for the general population[3] although the percentages were higher (ie 11 per cent v 24 per cent and 21 per cent v 43 per cent).[4]

(c) The proportion of the audit fee accounted for by activities outside the UK was higher among FTSE 350 companies. Half* of FTSE 100 companies and 33* per cent for FTSE 250 companies said that over 40 per cent of the audit fee was accounted for by non-UK activities compared with 14* per cent for non-FTSE-350 companies.

(d) There was a positive relationship between the size of the audit fee and the proportion of the audit fee being accounted for by non-UK activities. For audits where more than 40 per cent of the fee was accounted for by non-UK activities, 46* per cent had an audit fee that more £1 million. For audits where the

[3] The population figures provided by the public data set were for companies that had been in the FTSE 350 over the period 2001 to 2011 and companies in the Top Track 100 over the period 2006 to 2011.

[4] Available population figures show that for companies with an audit tenure up to five years 24 per cent had an audit fee of more than £1 million, whereas for those with a tenure of more than five years 43 per cent had an audit fee of more than £1 million. As with the survey data, the latter proportion was nearly double the former. The percentages were higher in the population statistics, but the mix of companies was different from that in the survey. In particular, the public database did not cover the smaller listed and private companies surveyed.

proportion of audit fee was accounted for by non-UK activities was lower, under 10* per cent of audits had a fee of more than £1 million.

Industry sector and index designation

14. Table 3 below compares the industry sector spread for the FTSE 350 respondents with that of all FTSE 350 companies at the time of the survey. It could be seen that the achieved sample broadly matched the overall population, although the proportion of companies in the financial services sector was slightly lower than in the total population. We did not analyse results at a sector level given insufficient sample size.

TABLE 3 **Distribution of FTSE 350 companies by sector, survey responses v population**

		per cent
	Population (in 2010)	*Survey*
QD1 base	**345**	**195**
Oil and gas	6	5
Basic materials	7	4
Industrial	18	15
Consumer goods	8	9
Health care	2	3
Consumer services	19	19
Telecommunications	2	3
Utilities	3	3
Financial	30	23
Technology	5	7
Business services (recruitment, real estate etc)	-	7
Business support services (waste, facilities mgmt etc)	-	2

Source: Public data set/IFF survey.

15. For each of the FTSE 100, FTSE 250, and Smallcap and fledgling company categories between 85 and 91 per cent had been publicly listed for at least six years. For AIM companies over 20 per cent had been listed for five years or less. These results were consistent with population data we had for FTSE 100 (88 per cent listed six years or more) and FTSE 250 (79 per cent listed six years or more) companies.

Size of company (turnover/employees)

16. Background questions were asked about the size of the company in terms of both their annual turnover, and the number of employees. As would be expected these two measures were highly correlated with one another.

17. Looking at the number of employees, in the survey nearly 75 per cent of FTSE 100 companies had more than 10,000, compared with 25 per cent for FTSE 250 companies and 12 per cent for non-FTSE-350 companies. For AIM companies surveyed, two-thirds had less than 250 employees, and none had more than 5,000. Table 4 gives a comparison of FTSE 350 versus Top Track 350 companies.

TABLE 4 **Distribution of employees by company category, FTSE 350 v Top Track**

QD4 Approximately how many people work in your organization globally?

Base: FTSE 350 = 195/Top Track 350 = 92

		per cent
	FTSE 350	*Top Track 350*
Fewer than 250 employees	10	4
250–499	5	10
500–999	9	12
1,000–4,999	22	43
5,000–9,999	15	13
10,000–24,999	18	13
25,000–49,999	8	2
50,000+	13	2

Source: IFF survey.

18. It could be seen that Top Track 350 tended to have fewer employees than FTSE 350 companies, though it was interesting to note that 10 per cent of FTSE 350 companies (most of which were in the FTSE 250) had less than 250 employees.

19. A similar pattern was seen in terms of turnover. In the survey 90 per cent of FTSE 100, 50 per cent of Top Track 100, 37 per cent of FTSE 250, and 17 per cent of non-FTSE-350 companies had a turnover of £1 billion or more. These figures closely matched data available for population, leading us to believe that the achieved survey sample was broadly representative.

TABLE 5 **Company turnover—survey distribution vs population**

per cent

	FTSE 100		*FTSE 250*	
	Population	*Survey*	*Population*	*Survey*
£25 million or less	0	0	3	3
£26–£250 million	2	0	29	19
£251–£999 million	13	9	39	41
£1–£5 billion	35	29	25	31
>£5–£10 billion	11	21	3	3
>£10 billion	38	40	0	3
Don't know	0	2	0	0

Source: Public data set/IFF survey.

20. Full distributions for the above questions can be found in the survey tabulations.

Market shares

21. Table 6 gives an analysis of the sample by audit firm. In particular it shows the share each firm had of audit engagements by index designation. We had compared these with known population shares for FTSE 350 and Top Track 100 audit engagements (see Appendix 5, 'Descriptive Statistics'). A number of differences had been found,[5] for example, audits carried out by Deloitte were over-represented in the sample. We did not, however, analyse results at a firm level and we observed that the market shares for Big 4 vs Mid Tier firms for FTSE 350 audit engagements were consistent with population figures for 2010. For Top Track 100 companies in the population the Big 4 had an 81 per cent share of engagements compared with 89 per cent in the sample.

[5] The differences found were most likely due, in part, to the differing quality of lists provided by parties during the early stages of the inquiry.

TABLE 6 **Share of engagements by company category (QA1)**

per cent

	All	*FTSE 100*	*FTSE 250*	*FTSE 350*	*Former listed*	*Small cap and fledgling*	*AIM*	*Top Track 100*	*Top Track 250*
Base	**474**	**58**	**137**	**195**	**52**	**74**	**58**	**35**	**57**
Deloitte	34	26	37	34	38	31	41	40	23
PWC	22	33	23	26	29	23	10	20	14
KPMG	22	24	20	21	21	23	12	17	35
E&Y	12	17	17	17	12	15	3	11	5
BDO	5	0	1	1	0	1	26	6	7
GT	2	0	1	1	0	4	2	6	5
PKF	1	0	1	1	0	1	3	0	5
Mazars	<1	0	0	0	0	1	2	0	0
RSM	<1	0	0	0	0	0	0	0	2
Other	<1	0	0	0	0	0	0	0	4
Big 4	90	100	96	97	100	92	67	89	77

Source: IFF survey.

22. Of the 474 companies in the sample only 47 companies were audited by non-Big-4 firms.

23. In the sample the Big 4 firms had a relatively stronger presence than Mid Tier firms in auditing larger companies, and in larger and more complex audits. In particular:

(a) On average the companies audited by the Big 4 firms were found to have a larger turnover than those audited by non-Big 4 firms. For Big 4 firms nearly 70* per cent of engagements were for companies with turnover of more than £250 million (compared with 28* per cent for non-Big 4 firms) and 33* per cent for companies with turnover of more than £1 billion (compared with 9* per cent for non-Big 4 firms).

(b) The average audit fee per engagement was higher for Big 4 firms. For the Big 4 firms the audit fees for 56* per cent of engagements were more than £250,000 (compared with 13* per cent for non-Big 4 firms) and for 33* per cent more than £500,000 (compared with 2* per cent for non-Big 4 firms).

(c) For 114 companies with more than 40 per cent of the fee accounted for by non-UK activities, 97 per cent of these were audited by Big 4 firms.

The respondents

24. We considered the key results to be:[6]

    (a) Two-thirds (66 per cent) of the FDs/CFOs surveyed had previously worked for one of the Big 4 audit firms (28 per cent had worked for PWC; 20 per cent for Deloitte; 15 per cent for KMPG; and 11 per cent for EY). This proportion was similar for FDs/CFOs of FTSE 350 companies.

    (b) Around 60 per cent of the ACCs surveyed had previously worked for one of the Big 4 audit firms (20 per cent had worked for PWC; 15 per cent for Deloitte; 16 per cent for KMPG; and 18 per cent for EY). Again the proportion was similar for ACCs for FTSE 350 companies.

    (c) Nearly all ACCs surveyed sat on or chaired another AC (of these 33 per cent on 1 other, 34 per cent 2 others, 20 per cent 3 others, 8 per cent 4 others, and 5 per cent 5+). The proportions were similar for ACCs of FTSE 350 and other companies.

Description of the audit relationship

25. We asked respondents about the length of tenure and non-audit services provided by the auditor. Again, where possible results were compared with the population statistics to test the representativeness of the sample.

Supply of non-audit services

26. We considered the key results to be:

    (a) For the great majority of companies—over 90 per cent—the audit firm also provided non-audit services. This was the case for all company categories.

    (b) For both Big 4 and non-Big 4 audit firms over 90 per cent of audit clients also used the firm for non-audit services.

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[6] All figures in this paragraph describe the sample and had not therefore been significance tested.

(c) The most frequently mentioned non-audit service was tax advice (mentioned by 75 per cent) followed by transaction advice (54 per cent), compliance advice (40 per cent) and consulting (26 per cent).

(d) Though there was not much difference within the FTSE 350 or between FTSE 350 and other companies in terms of the non-audit services provided:

(i) more FTSE 100 companies (60* per cent) used 'Compliance advice' than other companies (37* per cent), both discretely and as a whole; and

(ii) Top Track 100 companies (51* per cent) used more 'Consulting advice' than others (24* per cent).

Length of tenure

27. Table 7 shows results relating to length of tenure.

TABLE 7 **Length of tenure by company category (QA4)**

per cent

	All	*FTSE 100*	*FTSE 250*	*FTSE 350*	*Former listed*	*Small cap and fledgling*	*AIM*	*Top Track 100*	*Top Track 250*
Base	**474**	**58**	**137**	**195**	**52**	**74**	**58**	**35**	**57**
Under 1 year	3	3	0	1	2	3	3	11	4
1–2 years	10	5	9	8	12	7	12	9	16
3–5 years	19	9	13	12	19	20	28	20	32
6–10 year	28	17	32	28	19	31	41	20	28
11–20 years	22	33	24	27	23	16	17	11	11
Over 20	13	22	16	18	15	14	0	17	7
Don't know	5	10	5	7	6	3	0	6	4

Source: IFF survey.

28. We considered the key results to be:

(a) Length of tenure was longer for FTSE 350 companies than for other companies. Only 21* per cent of FTSE 350 companies had a tenure of up to five years compared with 39* per cent for non-FTSE-350.

(b) Over 55* per cent and 40* per cent respectively of FTSE 100 and FTSE 250 companies had tenures of more than ten years compared with 24* per cent of Top Track 350 companies.

(c) The above figures compared reasonably well with known data (see Table 8), again leading us to conclude that the survey was broadly representative of the population. The survey contained a smaller proportion of companies where the auditor had been appointed for 11 or more years (although a 'Don't know' response might be more likely for longer tenures).

TABLE 8 **Tenure—survey distribution vs population**

per cent

	FTSE 350	
	Survey	*Population*
Up to 5 years	21	21
6–10 years	28	23
11 or more years	45	57
Don't know	7	0

Source: Public data set/IFF survey.

(d) For both Big 4 and non-Big-4 firms 32 per cent of audit engagements had a tenure of up to five years.

Dimensions of the audit product

29. We asked respondents how important they thought certain factors to be in assessing the quality of an audit. The intention behind this question was to explore how important various aspects or dimensions of the product provided by auditors were to the customers. In a later question we asked customers how they selected auditors/ what attributes they looked for in order to get the product they wanted. Table 9 shows the proportion of respondents that considered a factor to be important or very important.

TABLE 9 **Importance of factors in assessing quality**

QA7 base: all respondents, FDs 343/ACCs 264

per cent

	FD/CFO		*ACC*	
	Very important	*Important*	*Very important*	*Important*
Ability to detect misstatements in your accounts	68	19	81	14
High degree of challenge by auditor	37	44	64	33
Reliability and usefulness of the audit report	29	35	46	33
Consistency of delivery worldwide?	26	27	31	26
The efficiency of the audit process	46	45	38	53
Ability to offer value added services	5	19	7	17
The independence of the audit firm	69	22	84	11

Source: IFF survey.

30. Key observations on these results were:

(a) For FDs the factors most frequently identified as very important or important were the efficiency of the audit and the independence of the firm followed by the ability to detect misstatements (efficiency/independence/competence).

(b) For ACCs the factors most frequently identified as very important or important were the ability to detect misstatements, the independence of the firm and a high degree of challenge by the auditor.

(c) For both the FD and ACC the factors least frequently identified as important were the ability to offer value added services.

31. Table 10 shows that for FTSE 350 FD/CFOs and ACCs, the factors most frequently identified as very important or important were the independence of the audit firm, the efficiency of the audit process, the ability to detect misstatements and a high degree of challenge by auditor

TABLE 10 **Importance of factors in assessing quality**

QA7 base: all FTSE 350 respondents, FDs 133 /ACCs 127

per cent

	FD/CFO		*ACC*	
	Very important	*Important*	*Very important*	*Important*
Ability to detect misstatements in your accounts	77	14	79	19
High degree of challenge by auditor	47	43	67	30
Reliability and usefulness of the audit report	31	40	48	29
Consistency of delivery worldwide?	35	29	43	25
The efficiency of the audit process	37	54	35	56
Ability to offer value added services	3	22	6	17
The independence of the audit firm	72	23	89	7

Source: IFF survey.

32. At a company level, the importance of worldwide consistency was rated more highly among those where a higher level of their audit fee was accounted for by non-UK activities. This result was statistically significant. For those companies where more than 40 per cent of the audit fee was accounted for by non UK activities, 92 per cent said that worldwide consistency was very important or important.

Who has most influence

33. We asked respondents who had the most influence on the selection of the auditor and the factors taken into account in appointing or reappointing an auditor. The results are summarized in Table 11.

TABLE 11 **Who is most influential in the selection of auditor**

QB1 base: All respondents

per cent

	AC members	*CFO FD*	*ACC*	*Wider management board members*	*Share-holders*	*No single person*
FD/CFO: All companies base 343	30	28	13	10	7	12
FD/CFO: FTSE 350 base 133	33	29	14	7	2	16
FD/CFO: non-FTSE-350 base 210	28	28	12	13	10	9
ACC: All companies base 264	38	14	19	11	2	15
ACC: FTSE 350 base 127	43	13	16	13	<1	15
ACC: non-FTSE-350 base 137	34	15	21	9	4	15

Source: IFF survey.

34. We considered the key results to be:

(a) the AC/ACC most frequently identified themselves as the most influential (with the exception of Top Track companies where FDs were mentioned more often);

(b) FDs consider themselves to have more influence than they were perceived to have among ACCs (this result was statistically significant); and

(c) the pattern of results was similar for FTSE and other companies.

Selection criteria

35. We asked FDs and ACCs how important they considered certain factors to be in the selection of auditors. Results were reported in Table 12. The pattern of results was similar across company categories.

TABLE 12 **Proportion of FDs and ACCs who considered a factor to be very important or important**

QB3 base: All respondents, FDs 343/ACCs 264

per cent

	FD/CFO		*ACC*	
	Very important	*Important*	*Very important*	*Important*
Experience and knowledge of the engagement partner	47	42	64	32
Experience and knowledge of the engagement team	22	57	29	55
Sector-specific expertise or experience	22	43	34	39
Expertise in the supply of audit related services	28	31	33	34
Strength of international network	29	24	32	20
Management preference for specific auditor	2	10	3	14
Previous and/or current relationship with audit firm	5	31	7	23
Reputation of audit firm with investors, corporate brokers, analysts or external advisers	43	41	40	42
Adverse comment against firm by regulator	22	39	28	37
Price	17	48	7	37
Expertise in the supply of non-audit services	3	10	3	13
Good working relationships with the audit team	29	57	25	63
Good corporate fit	12	44	13	39

Source: IFF survey.

36. Our observations on these results were as follows:

(a) For FDs and ACCs the factor most frequently identified as very important or important was the experience and knowledge of the engagement partner followed by good working relationships with the audit team and the experience and knowledge of the team.

(b) The reputation of the audit firm with investors, corporate brokers, analysts and external advisers was also identified as very important or important for 84 per cent and 82 per cent respectively of FDs and ACCs.

(c) The strength of the international network was identified as very important or important by 98 per cent of FDs and 85 per cent of ACCs of companies where the percentage of the audit fee accounted for by activities outside the UK was greater than 40 per cent.

(d) Price was identified as being very important or important by 65* per cent of FDs and 44* per cent of ACCs, and was more important for FDs.

(e) For FDs and ACCs the factors identified most infrequently as being important were management preferences and expertise in the supply of non-audit services.

37. Table 13 gives the same results for FTSE 350 respondents only.

TABLE 13 **Proportion of FDs and ACCs who considered a factor to be very important or important**

QB3 base: FTSE 350 respondents, FDs 133/ACCs 127

per cent

	FD/CFO		*ACC*	
	Very important	*Important*	*Very important*	*Important*
Experience and knowledge of the engagement partner	50	42	64	33
Experience and knowledge of the engagement team	23	59	35	50
Sector-specific expertise or experience	26	44	36	38
Expertise in the supply of audit related services	30	29	35	31
Strength of international network	41	23	48	19
Management preference for specific auditor	2	9	2	15
Previous and/or current relationship with audit firm	3	30	9	20
Reputation of audit firm with investors, corporate brokers, analysts or external advisers	38	45	41	45
Adverse comment against firm by regulator	17	45	27	39
Price	12	44	4	32
Expertise in the supply of non-audit services	2	7	3	13
Good working relationships with the audit team	23	60	26	64
Good corporate fit	8	47	18	36

Source: IFF survey.

38. FTSE 350 FD/CFOs listed the strength of international network as important more frequently than their non-FTSE colleagues (64* per cent compared with 46* per cent), and list price less frequently (56* per cent v 71* per cent).

39. The same applied for FTSE 350 ACCs. 67* per cent of FTSE 350 ACCs said that the strength of the international network was important compared with 37* per cent on non-FTSE-350 ACCs. 36* per cent of FTSE 350 ACCs said that price was important compared with 51* per cent of non-FTSE-350 ACCs.

Market testing

40. We asked respondents about the things they or others in their company did to maintain quality, efficiency and value for money.

41. First we asked respondents how often the company carried out specified activities. The results are given in Table 14. The responses were similar across the different company categories. We reported results split by FTSE 350 and other companies.

TABLE 14 **How often does your company carry out the following?**

QB4 base: All companies (FTSE 350 = 195/all other = 279)

per cent

	FTSE 350		*All other*	
	Every year	*At least every 5 years*	*Every year*	*At least every 5 years*
Post-audit review of quality and value of service provided—carried out internally or with the auditor	91	99	76	95
Benchmark or make formal comparisons with other audits	25	67	11	60
Have informal contact with other auditors outside a tender process	78	91	66	86
Negotiate audit fee	93	100	88	99
Request a formal proposal or presentation from the auditor before re-appointment	28	61	22	64

Source: IFF survey.

42. We considered the key results to be:

(a) Most companies regularly carried out reviews—internal or with their auditors—of audit quality and service—91* per cent of FTSE 350 companies carried this out annually compared with 76* per cent for other companies.

(b) Most companies renegotiated the audit fee every year and nearly all at least every five years.

(c) Two-thirds of companies carried out benchmarking or other formal comparisons with auditors at least every five years.

(d) Nearly two-thirds required auditors to make formal proposals or presentations before reappointment. Nearly half of companies (47 per cent) did both of these.

43. Nevertheless, we also found that:

(a) 15 per cent of FTSE 350 companies, nearly 30 per cent of Top Track 350 and 26 per cent of non-FTSE-350 companies did not carry out benchmarking or other formal comparisons with audits;

(b) about one-quarter of companies never requested a formal proposal or presentation from the auditor before reappointment—with no difference between FTSE 350 and other companies; and

(c) 10 per cent^ of FTSE 350 and 12 per cent^ of other companies had never carried out either of these activities (ie those specified in *(a)* and *(b)*).

44. We also asked about other activities not specified (at a company level there were 43 FTSE 350 responses): 44 per cent mentioned informal contact with their peer group; 30 per cent said that they drew on in-house experience and expertise; 22 per cent said that they carried out informal benchmarking and comparisons; and 7 per cent said that they reviewed the AIU reports.

45. With regard to informal activities, 78* per cent of FTSE 350 companies had informal contact with other auditors outside a tender process every year, compared with 66* per cent of other companies.

46. We asked respondents for companies that did carry out benchmarking or other comparisons, what factors they used in making these comparisons. We asked this as an open question. The coding frame was developed during the fieldwork using

completed responses available at the time and responses were coded after the interview was completed. Again the results were similar across categories of company. We report in Table 15 results for FTSE 350 companies and all other companies.

TABLE 15 **Benchmarking or other comparison factors**

QB6 base: All that make comparisons, FTSE 350 = 147/all other = 195

		per cent
	FTSE 350	*All other*
Comparisons of fee for audits in same sector/similar size and complexity	79	76
Sector and other expertise/experience/reputation of audit firm	29	33
Regional strength/geographical coverage	20	16
Experience of the audit team/partner	14	16
Quality of service	14	15
Audit techniques and approach and accounting treatments	10	15
Auditors used by others in sector	9	7
Quality of external audit report and internal reporting	5	9
Timeliness and efficiency in reporting	2*	9

Source: IFF survey.

*Statistically significant difference between FTSE 350 companies and other companies.

47. The key benchmarking or other comparison factors were the comparison of fees followed by the expertise of the audit firm and audit team. About three-quarters of companies that carried out benchmarking exercises compared their audit fees with those paid by other companies in the same sector and/or of a similar size and complexity. Nearly half^ of companies said that they looked at the expertise, experience and reputation of the audit firms and the audit team. Only 5^ per cent of respondents did not mention any of these three factors. The next most frequently mentioned factor was the geographical coverage of the audit firm. Other factors were mentioned by less than 15 per cent of respondents. 5^ per cent stated that they performed some type of informal benchmarking instead of comparing fees.

Tendering—frequency and tender lists

48. We asked respondents when their company last tendered its statutory audit. The results are given in Table 16. On average the frequency of tendering was lower

among FTSE 350 companies. We reported results split by FTSE 350 and all other companies.

TABLE 16 **How many years ago did your company go out to tender**

QB9 base: All companies, FTSE 350 = 195/all other = 279

		per cent
	FTSE 350	*All other*
Last year	5*	11*
Two years ago	5	8
Three to five years ago	13*	28*
Six to ten years ago	24	24
More than 10 years ago	25*	11*
Never tendered	15	10
Don't know	13	8

Source: IFF survey.

*Statistically significant difference between FTSE 350 and other companies.

49. We considered the key results to be: 23* per cent of FTSE 350 compared with 47* per cent of other companies had tendered their audit in the last five years; 24 per cent of FTSE 350 and other companies had tendered their audit in the last six to ten years; and 40 per cent of FTSE 350 and 21 per cent of other companies had either tendered the audit more than ten years ago or had never tendered the audit.

50. For audits tendered in the last five years we asked for further details on which auditors had been invited to tender. This question was answered by 175 companies, 44 were FTSE 350 companies and 131 non-FTSE-350 companies. In Table 17 we show the frequency with which audit firms were mentioned. Results are reported split by FTSE 350 and all other companies. We note that 9 cent of FTSE 350 (four companies) and 6 per cent of all other companies (eight companies) did not know which firms were invited to tender.

TABLE 17 **Proportion of respondents who mentioned a particular audit firm**

QB12 base: Companies who had tendered audit in last five years (multi-answered), FTSE 350 = 44/all other = 131

		per cent
	FTSE 350	*All other*
KPMG	75	63
Deloitte	66	62
PwC	68	61
EY	73*	54*
BDO	23	25
GT	14	23
Baker Tilly	2	7
PKF	2	5
RSM Tenon Group	0	5
Mazars	2	3
Smith & Williamson	2	2
Other	7	6
Don't know	9	6

Source: IFF survey.

*Statistically significant difference between FTSE 350 and other companies.

51. The most frequently mentioned audit firms were Deloitte, KPMG, PwC and EY followed by BDO and GT. Firms other than the Big 4, BDO and GT were mentioned by less than 3 per cent of FTSE 350 companies and 8 per cent of other companies. The average number of firms mentioned by each respondent, ie the number of firms invited to tender, was 3.4 (3.7 for FTSE 350; 3.4 for other companies).

52. As noted above (see paragraph 50), some companies that tendered in the last five years did not know the firms invited to tender. Table 18 provides further information for the 40 FTSE 350 companies that had tendered in the last five years and provided details of the firms invited to tender.

TABLE 18 **Details of tender lists for the 40 FTSE 350 companies**

QB12 base: Companies who had tendered audit in last five years and provided details of tender lists, FTSE 350 = 40

13 cases at least one Big Four and one Mid Tier:*	
1 Big 4 + 2 mid tier	1
1 Big 4 + 4 mid tier	1
2 Big 4 + 1 mid tier	1
2 Big 4 + 2 mid tier	2
2 Big 4 + 3 mid tier	1
3 Big 4 + 1 mid tier	4
4 Big 4 + 1 mid tier	2
4 Big 4 + 3 mid tier	1
27 cases of only Big 4 firms:	
2 Big 4	5
3 Big 4	8
4 Big 4	14

Source: IFF survey.

*Three out of the 40 tender lists included 'Other' as a firm invited to the tender. We have treated 'Other' as a Mid Tier firm invited to tender.

53. For FTSE 350 companies the tender lists for 27 out of the 40 companies included only Big 4 audit firms. For other companies 60 out of 123 invited only Big 4 firms, and 5 of the 123 tender lists did not include any Big 4 firms.

54. Mid Tier firms were invited to 13 out of the 40 tenders (33 per cent), but were successful in winning only one of these (a switch from one Mid Tier firm to another Mid Tier firm). The identity of the incumbent auditor was known for 26 (out of 40) tenders. Mid Tier firms were the incumbent at 5 companies and at each company the tender resulted in a switch: once to another Mid Tier firm and on four occasions to a Big 4 firm.

55. We also asked companies why tender lists had been limited to the firms mentioned. This was another open question, the responses to which were coded after the questionnaires were completed. About one-quarter of companies (and 20 per cent of FTSE 350 companies) mentioned that they had shortlists, the need not to waste time and that the number of firms invited to tender was sufficient to ensure a competitive process. Among FTSE 350 companies the most frequently mentioned factors were: the specialist knowledge of the audit firm, 43 per cent; the regional and geographic

coverage of the audit firm, 34 per cent; and the size of the firm, 30 per cent; 70 per cent^ of FTSE350 mentioned at least one of these. Looking at those who limited tendering to the Big 4, 48 per cent of FTSE 350 companies mentioned geographic coverage and 41 per cent the size of the audit firm.

Reasons for not tendering

56. We asked the companies that had not tendered their audit in the last five years why this was the case. This again was an open question.

57. The responses given by all FTSE 350 respondents are attached in Annex 2. We allocated these responses to four categories of interest. These were:

(a) positive comments: where the response suggested that the engagement had not been tendered as the company was content with the incumbent auditor's performance;

(b) negative comments: where the response suggested that the only reason for not tendering was the costs associated with doing so;

(c) mixed comments: where the response suggested that the decision not to tender was based on an assessment of the balance between the potential gains and costs of tendering; and

(d) other reasons: this includes responses which did not fall into any of the above. Some were just so bland that they did not provide much insight into the reasons for not tendering. Many were timing-related such as being recently listed, recent acquisitions, and other recent commercial developments.

58. Some judgement was required in the allocation to these categories, particularly between the 'positive' and 'mixed' categories. We coded a response as 'positive' where the response suggested that the primary reasons for the company not tendering was satisfaction with the performance of the incumbent auditor.

59. The results are shown in Table 19. 62 per cent of FTSE 350 respondents give 'positive' reasons for not switching; nearly 2 per cent 'negative' reasons; 20 per cent 'mixed' reasons; and 16 per cent 'other' reasons. The proportion of 'mixed' (26* per cent) among FTSE 100 respondents was higher than for FTSE 250 (16* per cent).

TABLE 19 **Classification of responses to B17 by respondent and company type**

per cent

	FD/CFOs only (Base: 88)	*ACCs only (Base: 76)*	*FTSE100 only (Base: 53)*	*FTSE 250 only (Base: 111)*
Positive	64	59	59	63
Negative	3	1	4	2
Mixed	20	19	26	16
Other	13	21	11	19
Total	100	100	100	100

Source: CC analysis of survey results.

60. There is variation in the 'positive' responses as follows: some stated briefly and clearly, with no qualification, that the company was content with the performance of their incumbent auditor; some focused on quality and independence, and either did not mention prices or suggested that price was a secondary consideration; and some mentioned costs associated with tendering and switching.

61. The 'mixed' responses were direct evidence of *(a)* the costs to a company of tendering and switching; *(b)* companies weighing in the balance the costs and benefits of tendering and switching in deciding whether to launch a competitive tender; and *(c)* that the costs may vary between companies. These responses indicated that the main costs associated with tendering and switching were: the opportunity cost of the management time involved in a tendering process; the opportunity costs of management time required in educating a new auditor; and the increased audit risk in the first two or three years of an engagement.

62. Some respondents mentioned that a lack of choice or differentiation between auditors as a factor in the decision not to tender.

Switching behaviour and effects

63. In the sample the proportion of tenders where the incumbent retained the engagement was 21^ per cent for FTSE 350 and 30 per cent for all other companies.[7]

64. We received responses for 133 companies, including 33 FTSE 350 companies, which switched auditors in the last five years. In total we had responses from 104 FDs and 66 ACCs. Results from the public database suggested that 45 FTSE 350 companies switched auditor over the five-year period 2006 to 2010. We asked questions on the reasons for switching and the effect of switching.

65. We asked an open question on the principal reasons for switching. Among the FTSE 350 companies, for both FDs and ACCs the most frequently mentioned factors were: to get a better quality of service in the delivery of the audit (30 per cent of FDs, 44 per cent of ACCs); to get a better price (26 per cent of FDs, 17 per cent of ACCs); to use a firm with better sector experience (26 per cent of FDs, 22 per cent of ACCs). 30 per cent of FD/CFOs also mentioned a policy to switch regularly and/or to avoid complacency.

66. We note that the following factors were mentioned infrequently by both FDs and ACCs: to improve the quality of the audit opinion or report; to get a better quality of service in the provision of NAS; the previous auditor made a mistake or performed poorly; and impressed by past dealings/recommended to us.

[7] In computing this we crossed questions A4 (For how many consecutive years had your current audit firm, or one of their predecessors, performed the statutory audit for your company?) and B9 (How many years ago did your company last go out to tender for statutory audit services?). In order to have a reliable analysis, we considered only tenders issued in the last ten years. We disregarded options 'never' and 'don't know' in both questions. The proportion of tenders where the incumbent retained the engagement was computed considering all the tenures that had lasted longer than the date of last tender.

67. Regarding the effect of switching we asked three open questions which were coded during the interview covering price, quality and internal costs. For many companies, switching was said to have resulted in lower fees and/or improvements in quality, with 44 per cent[8] saying that the audit fee was lower in the first and following years (52 per cent of FTSE 350 companies) and 46 per cent that quality was better in the first and following years (48 per cent of FTSE 350 companies). About 20 per cent^ reported both the reduction in audit fee and the improvement in audit quality. About 75^ per cent said that switching resulted in some benefits in first and/or following years.

68. Switching was said to have no material impact on fees by 21 per cent (by 15 per cent of FTSE 350 companies), quality by 20 per cent (by 18 per cent of FTSE 350 companies) and internal costs by 59 per cent (52 per cent of FTSE 350 companies). 16 per cent said that audit fees were higher as a result of switching (15 per cent among FTSE 350 companies) and 13 per cent that internal costs were higher in both the first and following years (15 per cent among FTSE 350 companies.

69. For 80 companies (including 22 FTSE 350 companies) switching was said to have resulted in a change in quality, with 70 saying that the change was positive and 10 saying that the change was negative at least in the first year. The most frequently mentioned changes were: better audit processes and planning (by 35 per cent of FTSE 350 companies); higher quality and better skilled staff (by 45 per cent of FTSE 350 companies); better sector experience and understanding of the client's business (by 25 per cent of FTSE 350 companies); more thorough approach (by 25 per cent of FTSE 350 companies); and better quality reporting and feedback (by 15 per cent of FTSE 350 companies).

[8] This includes companies which responded that the audit fee was lower and companies which responded that the audit fee was lower in the first year and increased in following years but remained lower than the fee before switching auditor.

70. The verbatim responses to the question asking about the impact on internal costs are reported in Annex 3. The responses suggest that some respondents did not understand the question. In particular, that they understood internal costs to be referring to internal audit costs or other expenditure on internal auditing, or financial controls. Nevertheless, the remaining responses suggested a mixture of experiences in terms of costs incurred through switching auditor.

71. A theme in the verbatim responses was that for those companies that had switched the experience of tendering and switching was for some disruptive and, while not incurring direct costs, was costly in terms of the opportunity cost of management time. Where respondents thought there was an increased cost the cost was greatest (and often only) in the first year after a switch. Some examples that captured this theme included:

(a) FTSE 100 FD/CFO:

> Well, there was some significant additional management time and effort associated with managing the tendering process and there was probably a significant addition of time and effort in the first year of the new audit because we had to spend a lot more time explaining to the audit team how the systems worked, the controls worked and how we put the numbers together. Following years, I would say that there was no significant change from the time and effort and cost that there was in an average year for the prior audits.

(b) FTSE 250 FD/CFO:

> Well, it was time-consuming, both going through the tender process and then the selection process, and then there's the briefing of new audit teams, both centrally and in the operations, including overseas operations, so there was an amount of management time that was used up as a consequence of the change. Direct additional costs of

changing audit? Nothing, other than people working a bit harder to accommodate it.

(c) FTSE 250 FD/CFO:

I would say, for the first year, they were probably higher, but that was really part of the learning curve. [Asked by interviewer if costs decreased in the following years] Yes, they would have done.

(d) FTSE 250 FD/CFO:

Difficult to measure, but it's quite disruptive. I mean, it's not necessarily a straight pounds and pence thing but a disruption of people. You know, more interview time, etc, etc. There is a cost attaching to people's time. It was higher in the first year and then they just revert back, but it didn't go lower, I can assure you. It's just higher in the first year and then the same afterwards. You get a bubble of switch, so you probably haven't got the box. There is a cost to it, so if people are saying this is a low cost thing, it's not. It's very disruptive, so you wouldn't want to do it often.

Triggers for switching

72. We asked all respondents to consider a number of potential triggers for switching, in particular what events would cause a company seriously to consider switching auditor. The responses for FDs and ACCs of FTSE 350 companies are given in Table 20. The pattern of results was similar for all company categories.

TABLE 20 **Triggers seriously to consider switching**

QC6 base: All FTSE 350 companies, FDs 133/ACCs 127

per cent

	FDs/CFOs		*ACCs*	
	Very likely	*Likely*	*Very likely*	*Likely*
A problematic working relationship between the auditor and management	17	44	13	46
A disagreement with the auditor over an audit judgement or accounting treatment	2	16	3	19
A substantial increase in the audit fee	33	38	16	39
If the auditor started auditing one of your company's competitors	5	15	7	21
Scandal in the UK or another country related to current auditor	6	32	10	35
Rotation of audit partner	3	13	6	24
Being approached by another audit firm	0	1	0	0
Pressure from shareholders, bankers, lawyers or analysts	13	41	12	50
Change in ownership or location of your company, or in nature and scale of activities	10	37	7	28
Appointment of a new CFO, FD or audit chair	2	17	3	17
The company moving in or out of the FTSE 350 listing	0	6	0	4
Complacency of audit firm	44	42	58	36
Disagreement or problem with provision of non-audit services	1	7	3	11

Source: IFF survey.

73. The potential trigger most frequently identified as very likely or likely to prompt a company seriously to consider switching was the complacency of the audit firm followed by: a problematic working relationship between auditor and management; a substantial increase in the audit fee (particularly among FDs); and pressure from shareholders, bankers, lawyers or analysts (particularly among ACCs).

74. The potential triggers most infrequently mentioned as very likely or likely triggers are: the company moving in and out of the FTSE 350; disagreement or problem with provision of NAS; and being approached by another audit firm.

75. We asked whether there were any other triggers, not mentioned by the interviewer. Over 55 per cent of FDs and over 40 per cent of ACCs for the FTSE 350 companies said poor quality audit.

Formal and informal contact

76. We asked respondents whether they had in the past five years been approached informally or formally by an audit firm offering to provide audit services to their company and, if yes, by whom.

77. Among FDs for FTSE 350 companies, 20 per cent said that they had been formally approached and 68 per cent informally. The figures for ACCs were 7 per cent and 46 per cent respectively. The figures were much the same for both FDs and ACCs working for other companies. In total 71 per of FTSE 350 FDs, 46 per cent of FTSE 350 ACCs and 64 per cent of FTSE 350 companies had been approached in some way.

78. These approaches were predominately by Big 4 firms. Of those companies approached, 77 per cent had been approached by Big 4 firms only. Each of these firms was mentioned by at least 45 per cent of FTSE 350 FDs and ACCs associated with companies that had been approached. The next most frequently mentioned firms were BDO and GT. Around 10 per cent of FTSE 350 FDs had been approached by these firms, but less than 10 per cent of ACCs. For non-FTSE-350 companies that had been approached a higher level of contact had been made by both BDO and GT (about one-quarter for FDs and just under 20 per cent for ACCs).

Forced diversion

79. We asked FDs and ACCs which audit firms their company would formally consider if their current statutory auditor were to cease trading. We did not suggest the names of firms to respondents.

80. Generally for FTSE 350 companies, both FDs and ACCs predominately listed Big 4 firms. 14 per cent of FDs said that they would formally consider GT and 13 per cent

they would consider BDO. Among ACCs the figures were 17 per cent and 15 per cent respectively. Neither FDs nor ACCs of FTSE 350 would consider a non-Big-4 firm alone, while 23 per cent of both FDs and ACCs would formally consider a combination with Big 4 and non-Big-4. 72 per cent of FTSE 350 companies said that they would consider only Big 4 firms.

81. For both FDs and ACCs of other companies the Big 4 firms also dominated, and around 50 per cent said that they would only consider the Big 4. However, these companies would be more willing formally to consider GT (31 per cent of FDs, 30 per cent of ACCs); BDO (23 per cent of both FDs and ACCs); and Baker Tilly (10 per cent of FDs, 7 per cent of ACCs).

82. Among FTSE 350 companies (sample size 195): five did not state any preferences; nine identified one firm; 28 identified two; 113 identified three; 22 identified four; and 18 identified five. These results suggested that 78^ per cent of FTSE 350 companies had a choice of at least four firms (including their existing auditor) (ie (113+22+18)/ 195 = 0.78).

83. We used these figures to calculate diversion ratios. Table 21 shows the types of firm that would be considered if their current statutory auditor ceased trading. For those currently audited by the Big 4, 25 per cent said that they would consider GT and 22 per cent BDO. A total of 7 per cent of these respondents said that they would consider other non-Big-4 firms. More detailed information can be found in the presentation and the survey tabulations.

TABLE 21 **If your current statutory auditor ceased trading unexpectedly, which firms would you formally consider**

QC9 base: All companies (474)

per cent

	Firms would formally consider			
Current auditor	*Big 4 only*	*Combination*	*Non-Big-4 only*	*Don't know*
Big 4	61*	35	2*	2*
Non-Big-4	26*	45	19*	11*

Source: IFF survey.

*The proportion of companies currently audited by a Big 4 firm that would, for example, formally consider a Big 4 auditor, is significantly different from the proportion of other companies that would do so.

84. Table 22 gives the same results for FTSE 350 companies only.

TABLE 22 **If your current statutory auditor ceased trading unexpectedly, which firms would you formally consider, FTSE 350**

QC9 base: All companies (195)

per cent

	Firms would formally consider			
Current auditor	*Big 4 only*	*Combination*	*Non-Big-4 only*	*Don't know*
Big 4 (190)	73	24	0	3
Non-Big-4 (5)	60	40	0	0

Source: IFF survey.

Reasons for not considering non-Big-4 firms

85. We asked FDs and ACCs who said that their company would formally consider only Big 4 firms what the reasons for this would be. This was an open question based on the responses of:

(a) 189 out of 343 FDs (55 per cent) who said that their companies would only consider Big 4 audit firms (97 of these were FDs for FTSE 350 companies); and

(b) 158 out of 264 ACCs (60 per cent) who said that their company would only consider Big 4 firms (93 of these were ACCs for FTSE 350 companies).

86. The coded responses for FDs and ACCs working for FTSE 350 companies are reported in Table 23.

TABLE 23 **FTSE 350 companies that would formally consider only Big 4 firms, reasons for this**

QC10 FTSE 350 companies, FDs 97/ACCs 93

	per cent	
	FDs	*ACCs*
Size audit firm/geographical coverage	59	69
Sector-specific knowledge/experience	27	45
Reputation not specific	23	11
Our shareholders/investors/banks expect certain standards	13	15
Size and complexity of the company/audit	16	20
Better calibre/trained staff	15	19
Efficiency in carrying out audits/rigorous audit procedures	9	6
Higher quality service	14	11
A requirement of lenders/banks	2	2
Technical knowledge	5	9
Range of competencies	5	4
Bench strength	4	4
Deliver to a higher technical standard	2	2
Staff at the company have links to the Big 4	1	-

Source: IFF survey.

87. For FTSE 350 companies the most frequently mentioned reason, by both FDs and ACCs, was the size and geographic coverage of the Big 4 audit firms (59 per cent and 69 per cent respectively). Sector knowledge and experience (27 per cent and 45 per cent), reputation (23 per cent and 11 per cent), better calibre/trained staff (15 per cent and 19 per cent) and size and complexity of the audit (16 per cent and 20 per cent) were other frequently mentioned reasons. Only a small proportion of companies (8^ per cent) with no overseas audit cited the size and geographic coverage.

88. For non-FTSE 350 companies the pattern of responses was broadly the same. However, the importance of size and geographic coverage of the Big 4 audit firms was identified less frequently by both FDs (38* per cent v 59* per cent) and ACCs (51* per cent v 69* per cent). Also ACCs of non-FTSE 350 companies mentioned reputation more frequently than FTSE 350 ACCs (23* per cent and 11* per cent respectively).

Factors limiting choice between Big 4 firms

89. We also asked FDs and ACCs who said that their company would consider only Big 4 firms whether there were factors that would limit choice between Big 4 firms. The results for FTSE 350 companies are shown in Table 24.

TABLE 24 **Factors limiting choice between Big 4 firms, frequency mentioned**

QC11 base: FTSE 350 companies, FDs 97/ACCs 93

	per cent	
	FDs	*ACCs*
That certain auditors provide your company with other, non-audit services	21	15
Conflict of interest/independence	4	3
The fact that certain auditors provide audit services to competitors	2	8
Weaknesses in the strength or coverage of the international network	2	5
The lack of certain sector expertise	6	2
The fact that certain auditors provide other, non-audit services to competitors	5	3
Previous bad experience (including no experience, heard bad things, don't know if we could trust them)	1	-
The fact that certain auditors provide services to competitors (unspecified)	2	2
Other	15	16
None of these	60	65

Source: IFF survey.

90. For FTSE 350 companies, 60 per cent of FDs and 65 per cent of ACCs said that there were no factors limiting choice between Big 4 firms. For those that did, the most frequently mentioned factor was the provision of non-audit services (21 per cent of FDs and 15 per cent of ACCs).

91. For other companies similar proportions said that there were no factors limiting choice between Big 4 firms (71 per cent of FDs and 66 per cent of ACCs). For those that did, the most mentioned factors were provision of non-audit services, conflicts/ independence and a previous bad experience. Finally, 15 per cent of FD/CFOs and 16 per cent of ACCs mentioned 'other' reasons.

Characteristics of longer tenure engagements

92. In this section we give the survey results for FTSE 350 and other companies that had neither switched auditor nor tendered their audit engagement in the last ten years. We also compared the characteristics of these companies with those that had tendered and switched in the last ten years. This analysis cannot be replicated using the tabulated results. For this reason we report some results that were found not to be statistically significant.

93. Four hundred and nineteen companies (165 FTSE 350 and 254 non-FTSE-350 companies) responded to questions on the number of consecutive years their auditor, or one of their predecessors, performed the statutory audit for that company[9] and how many years since the company last went out to tender for statutory audit services.[10]

94. From this sample we defined four mutually exclusive categories:

(a) companies that switched auditor following a tender during the last ten years, referred to as the shorter-tenure companies;

(b) companies that did not switch auditor and did not go out to tender during the last ten years (or had never tendered), referred to as the long-tenure companies;

(c) companies that switched auditor during the last ten years without going out to tender (we did not include these companies in our comparator group a) because the switch had not followed a tender); and

(d) companies that went out to tender during the last ten years but did not switch auditor.

[9] CC survey, question A4.
[10] CC survey, question B9.

95. Of the 419 companies, one-quarter did not switch auditor and did not tender (ie the long-tenure companies), 7 per cent switched auditor without tendering and 11 per cent held a tender and retained the incumbent audit firm during the last ten years. This is shown in Table 25 below. 57 per cent of companies both tendered and switched audit firm in the last ten years (shorter-tenure companies).

TABLE 25 **Switching and tendering behaviour during last ten years (all companies)**

per cent

	Tendered in last 10 years	*Not tendered in last 10 years*
Switched auditor in last 10 years	57	7
Not switched auditor in last 10 years	11	25

Source: CC.

Note: Total sample base: 419.

96. Table 26 presents the switching and tendering behaviour separately for FTSE 350 companies and other companies. The percentage of long-tenure companies was 36* per cent among FTSE 350 companies only and 18* per cent for non-FTSE-350 companies. Conversely, 44* per cent of FTSE 350 companies were shorter-tenure companies, compared with 65* per cent of all other companies.

TABLE 26 **Switching and tendering behaviour among FTSE 350 companies and other companies**

per cent

	Tendered in last 10 years		*Not tendered in last 10 years*	
	FTSE 350 companies Base:165	*Other companies Base: 254*	*FTSE 350 companies Base:165*	*Other companies Base: 254*
Switched auditor in last 10 years	44	65	10	5
Not switched auditor in last 10 years	10	12	36	18

Source: CC.

Note: Total sample base: 419.

Company characteristics

97. Table 27 presents results on the turnover of long- and shorter-tenure companies for FTSE 350, non-FTSE-350 and for all companies. Surveyed companies with longer tenures tended to be larger than those with shorter tenures. In particular, 43* per cent

of long-tenure companies had an annual turnover greater than £1 billion, whereas 41* per cent of shorter-tenure companies had an annual turnover smaller than £0.25 billion. Although we observed differences in the distribution of turnover between long- and shorter-tenure FTSE 350 companies, we found no statistical significance between the differences.

TABLE 27 **Annual turnover of long- and shorter-tenure companies**

per cent

	All companies (Base: 413)		*FTSE 350 (Base:164)*		*Non-FTSE-350 (Base:249)*	
Annual turnover	*Long-tenure Base:104*	*Shorter-tenure Base: 234*	*Long-tenure Base:59*	*Shorter-tenure Base: 72*	*Long-tenure Base:45*	*Shorter-tenure Base: 162*
<£0.25 bn	24	41	15	14	36	52
£0.25–£1 bn	33	35	32	37	33	34
> £1 bn	43	24	53	49	31	14

Source: CC.

98. Table 28 shows the distribution of employees for long- and shorter-tenure companies. Long-tenure companies tended to have a greater number of employees. In particular: 45* per cent of shorter-tenure companies had fewer than 1,000 employees compared with 29* per cent of long-tenure companies, and 16* per cent of shorter-tenure companies had more than 10,000 employees compared with 33* per cent of long-tenure companies. Among FTSE 350, we did not observe this difference between long- and shorter-tenure companies.

TABLE 28 **Number of employees among long- and shorter-tenure companies**

per cent

	All companies (Base: 419)		*FTSE 350 (Base: 165)*		*Non-FTSE-350 (Base: 254)*	
Number of employees	*Long-tenure Base:106*	*Shorter-tenure Base: 236*	*Long-tenure Base:60*	*Shorter-tenure Base: 72*	*Long-tenure Base:46*	*Shorter-tenure Base: 164*
<1,000	29	45	30	26	39	53
1,000–10,000	38	39	35	38	41	39
>10,000	33	16	42	36	20	8

Source: CC.

99. The analysis of the percentage of audit fee outside the UK did not show any substantial or statistically significant difference between long- and shorter-tenure companies. The results are summarized in Table 29.

TABLE 29 **Percentage of fee outside the UK for long- and shorter-tenure companies**

per cent

Percentage of fee outside the UK	*All companies (Base: 386)*		*FTSE 350 (Base: 151)*		*Non-FTSE-350 (Base: 235)*	
	Long-tenure Base:100	*Shorter-tenure Base: 217*	*Long-tenure Base:56*	*Shorter-tenure Base: 68*	*Long-tenure Base: 44*	*Shorter-tenure Base: 149*
0%	35	36	21	19	52	44
1–40%	34	39	29	38	41	39
41–100%	31	25	50	43	7	17

Source: CC.

100. In the Financial industry, the proportion of shorter-tenure companies was higher for non-FTSE-350 (70* per cent) compared with the corresponding group of Financial companies in the FTSE 350 (43* per cent). Table 30 summarizes a comparison among the two groups across representative industries according to length of tenure and company category.[11]

[11] We considered only industries having a representative sample of at least 30 observations overall. Therefore the Oil and Gas (26 observations overall), Basic Materials (17), Healthcare (17), Telecoms (11), Utilities (16) industries are not included in this analysis.

TABLE 30 **Industry comparison across long- and shorter-tenure companies**

	All companies (Base: 419)			*FTSE 350 (Base: 165)*			*Non-FTSE-350 (Base: 254)*		
	Total Industry base	*Total long-tenure Base:106 %*	*Total shorter-tenure Base:236 %*	*FTSE 350 Industry base*	*Long-tenure Base: 60 %*	*Shorter-tenure Base: 72 %*	*Non-FTSE-350 Industry base*	*Long-tenure Base: 46 %*	*Shorter-tenure Base: 164 %*
Financial	83	25	57	40	35	43	43	19	70
Consumer services	82	33	50	31	35	45	51	31	53
Industrial	65	29	58	24	46	42	41	19	68
Consumer goods	35	31	51	13	54	23	22	18	68
Other	34	29	47	17	29	47	17	29	47
Technology	33	18	70	10	40	50	23	9	78

Source: CC.

Company audit preferences

101. Among FTSE 350 companies, 91* per cent of long-tenure companies considered the strength of the international network as an important factor in deciding to appoint or reappoint a statutory auditor, compared with 76* per cent of shorter-tenure companies. We did not, however, find a significant difference between the proportion of long- and shorter-tenure companies with more than 40 per cent of the audit fee overseas.

102. We found that 69* per cent of all long-tenure companies did not request a formal proposal or presentation from the auditor before reappointment, compared with 52* per cent for shorter-tenure companies.

103. 50* per cent short-tenure companies were usually approached by Big 4 firms only compared with 71* per cent of long-tenure companies. However, if we consider FTSE 350 companies only, there was no difference between long- and shorter-tenure companies.

104. 77* per cent of shorter-tenure companies considered the appointment of a new FD or ACC as a potential trigger compared with 56* per cent of long-tenure companies. We did not find any other substantive differences in what would trigger a switch of audit firm between long- and shorter-tenure companies.

International networks

105. In this section we report results relevant to the importance of the geographic coverage of the international network and consistency of quality across networks.

Big 4 firms

106. In general terms the Big 4 firms had a stronger presence in international audits. In particular, for 114 companies with more than 40 per cent of the audit fee accounted for by non-UK activities, 97 per cent of these were audited by Big 4 firms.

'Consistency of delivery worldwide' in assessing audit quality (Question A7)

107. The consistency of delivery worldwide in assessing audit quality was more important to FTSE 350 companies, companies with a larger proportion of the audit fee accounted for by non-UK activities and larger companies (these characteristics would be correlated). In particular:

(a) more FTSE 350 companies (66* per cent) said that this was important than other companies (47* per cent);

(b) within the FTSE 350, this was more important to FTSE 100 companies (84* per cent) than to FTSE 250 companies (58* per cent);

(c) 92* per cent of companies with more than 40 per cent of the audit fee accounted for by non-UK activities said that international consistency was important compared with 64* per cent of companies with between 1 and 40 per cent of the audit fee accounted for by non-UK activities and 12* per cent for companies with no international audit requirement; and

(d) 71* per cent of companies with turnover greater than £1 billion considered international consistency to be important compared with 56* per cent of companies with turnover between £250 million and £1 billion and 40* per cent of companies with turnover of less than £250 million.

Importance of 'Strength of international network' when looking to appoint/ reappoint (Question B3)

108. The strength of the international network was said to be important in the (re)appointment of an auditor by 64* per cent of FTSE 350 companies and 45* per cent of other companies.

109. The proportion that considered this factor to be important was 96* per cent for companies with more than 40 per cent of the fee accounted for by non-UK activities. This was significantly higher than for companies with between 1 and 40 per cent of the audit fee associated with international activities (62* per cent) and companies with no international audit requirement (8* per cent).

Benchmarking on 'Regional strength/geographic coverage' (Question B6)

110. Of the 342 companies that carried out some form of benchmarking exercise or other formal comparisons with other audits, 18 per cent identified regional strength and geographical coverage of the audit firm as a factor in these exercises. We note that this could include strength across the UK.

111. Regional strength and geographic coverage was more often a factor in benchmarking exercises carried out by companies with more employees. In particular, this was said to be a factor by 10* per cent of the companies with fewer than 1,000 employees and 22* per cent of the companies with more than 1,000 employees.

112. 35* per cent of the companies with more than 40 per cent of the fee accounted for by non-UK activities benchmarked on regional strength and geographic coverage compared with 14* per cent for those with a non-UK fee element of between 1 and 40 per cent and only 5* per cent for those with no non-UK element to the fee.

'Regional strength/geographical coverage' given as a reason to limited tender to certain firms (Question B13)

113. Of the 175 companies that had tendered in the past five years, 24 per cent identified regional strength and geographical coverage as a factor limiting who they invited to tender. Again we note that this could include coverage across the UK.

114. Significant differences emerged when we looked at results according to the proportion of the fee accounted for by non-UK activities. In particular: 48* per cent of the companies with more than 40 per cent of the fee accounted for by non-UK activities gave regional strength and geographical coverage as a reason for limiting the tender to certain firms, compared with 22* per cent for those with a non-UK fee of between 1 and 40 per cent and 10* per cent for those with no non-UK element to the fee.

'Size audit firm/geographical coverage' given as a reason for not considering outside the Big 4 if current auditor ceased trading (Question C10)

115. 54 per cent of the 260 companies who would only consider the Big 4 gave size of the audit firm and geographical coverage as a reason. As this factor covered both size and coverage, the number of answers relating to geographical coverage alone was unknown. Some examples of the detailed answers given included:

(a) 'Ability to sustain quality in a number of our overseas/international operations. In some of the countries in which we operate, the smaller firms do not have an established audit practice (well-established audit practice)'.

(b) 'Geographical coverage, the others don't have it. Deep technical expertise and quality of team—in UK and in our overseas markets'.

(c) 'Because we are an international group. These are international companies. I am not working with correspondent firms of variable quality depending on territory.

116. FTSE 350 companies were significantly more likely to cite this factor than other companies (64* per cent vs 43* per cent), as were companies with higher annual turnover; with more employees; and those with a high non-UK audit fee.

'Weaknesses in the strength or coverage of the international network' as a factor for restricting choice **within** *the Big 4 (Question C11)*

117. Only 4 per cent of the 260 companies answering this question gave this response to the open-ended question.

Methodology for testing statistical significance

Introduction

1. This annex sets out the approach taken to testing the robustness of certain results reported in this appendix.

2. We mostly relied on the significance testing provided by IFF. The contents of this annex are as follows:

   (a) an overview of the data and how it is used;

   (b) the use and calculation of confidence intervals;

   (c) the application of the FPC; and

   (d) the calculation of significance tests.

Overview and use of data

3. In the appendix we defined the population, the sample frame, and the achieved sample (see notes to Table 1 and paragraph 8). For the purposes of significance testing:

   (a) whilst the overall population of the survey was comprised of all the companies in all categories, the relevant population would vary depending on the results being analysed. Generically we denoted the relevant population with N; and

   (b) whilst the achieved sample was comprised of all the companies in each category for which we had responses, as above, the relevant sample under consideration would vary and was generically denoted with *n*.

4. For instance, looking at FTSE 100 companies only, the population under consideration was composed of 100 companies (*N*=100), and the achieved sample was 58 (*n*=58).[1]

5. The minimum base size was a sample size threshold level under which a statistical analysis should not be performed because it was not sufficiently reliable. In line with good practice, we reported findings only when the base sample size was 30 observations or more. This figure was not imposed by statistical theory, but was based on judgement. Further information on data collection and minimum base size can be found in the IFF report.

Confidence intervals

6. A confidence interval was usually expressed as the estimated proportion, or mean, plus or minus its margin of error at a given confidence level. A confidence level indicates the probability that the true population parameter lies within the estimated interval, given a random sample extracted from the population. Whilst we did not report confidence intervals in the main paper we referred to these in paragraph 8 of the appendix, and below.

7. In the analysis of the survey results we used the 95 per cent confidence level in computing confidence intervals, ie that the true population parameter was expected to lie within the confidence intervals in 95 per cent of the cases.

8. Assuming that the sample was extracted from a population that had a Normal distribution, the formula for a confidence interval for sample sizes greater than 30 observations was the following:

[1] This example is extracted from Table 1 of the appendix.

$$x - z\frac{s}{\sqrt{n}} < \mu < x + z\frac{s}{\sqrt{n}}$$

Where μ was the (unknown) population parameter or characteristic of interest, x was the sample characteristic describing the relative population parameter, s was a measure of the variability of the sample (the so-called standard deviation), n was the sample size and z was a value corresponding to the level of confidence chosen for a Normal distribution. The term $\pm z\frac{s}{\sqrt{n}}$ was also known as the margin of error.

9. For a Normal distribution and a sample size of at least 30 observations, a 95 per cent level of confidence corresponded to a value of z equal to 1.96 ($z = \pm 1.96$). For example, if 50 per cent of the respondents to a question in the survey stated a characteristic of an audit firm as 'very important' at a confidence level of 95 per cent, with a margin of error equal to (plus or minus) 3.1 per cent, it meant that if the survey were conducted 100 times, the percentage of the population that would list this characteristic as 'very important' would range between 46.9 and 53.1 per cent in 95 of the 100 surveys.[2]

Finite population correction

10. In order to compute confidence intervals, statistical theory assumed that the population was much (infinitely) greater than the sample. For finite populations and samples greater than 5 per cent, a correction factor must be taken into account. In this case we had finite populations and achieved samples that were considerably more than 5 per cent of the population. We therefore applied an FPC.

11. The FPC, which took a value between 0 and 1, was used as a multiplier that reduced the margin of error calculated for a random sample selected from a large population and so narrowed the confidence intervals, ie it provided better estimates of the

[2] Using the above confidence interval notation: $0.5 - 0.031 < \mu < 0.5 + 0.031$.

parameters of interest. The FPC was computed using the information available on the population N and on the sample n:

$$FPC = \sqrt{\frac{N-n}{N-1}}$$

12. The formula of a confidence interval including a FPC was the following:

$$\mathrm{x} - \mathrm{z}\frac{\mathrm{s}}{\sqrt{\mathrm{n}}}\mathrm{FPC} < \mu < x + z\frac{\mathrm{s}}{\sqrt{\mathrm{n}}}\mathrm{FPC}$$

13. If we considered the example in paragraph 11—where 50 per cent of respondents rated a characteristic of an audit firm as 'very important' at a confidence level of 95 per cent, with a margin of error equal to (plus or minus) 3.1 per cent—using the information in Table 1 of the main document, the FPC for the company-level sample of FTSE 100 companies was equal to 0.65 and the relative margin of error became approximately equal to 2.0, reducing the spread of the confidence interval.[3] This implied that, given the sample characteristics, in 95 per cent of the cases a number of FTSE 100 companies between 48.0 and 52.0 were likely to assess this specific audit firm characteristic as 'very important'.

Statistical significance testing

14. A statistical significance test involved the choice of a null hypothesis—a statement regarding the survey findings that aimed to explain a result, usually denoted as H_0—and of an alternative hypothesis H_A, that negated such an explanation. The two hypotheses were therefore stated in such a way to be mutually exclusive. The test allowed us either to accept the null hypothesis H_0, or to reject it in favour of H_A.

[3] The information used to compute the FPC in this example is extracted by Table 1: *N*=100; *n*=58. In this case this leads to a margin of error of 2.015.

15. When testing hypotheses a 95 per cent significance level had been used. There was only a 5 per cent chance (confidence level) that the null hypothesis was rejected by coincidence rather than as a result of a pattern in the observations.

16. We used a (two-tailed) two-proportions Z-test to analyse company-level results to assess whether observed differences in responses for different company categories were significantly different.

The two-proportions Z-test

17. To apply the two-proportions Z-test the following conditions must be met: samples for each population were selected using simple random sampling; the samples were independent, ie there is no relation between them; and each sample size n was greater than or equal to 30 observations. In this case the achieved sample was not a random sample of the population. Nevertheless for the purposes of carrying out significance testing we assumed this to be the case. In particular, we assumed that there was not a systematic bias in the sample (see paragraphs 11 to 23 of the appendix).

18. For the two-proportions Z-test the null hypothesis was that there was no difference between two groups with respect to a specific characteristic and the alternative hypothesis was that the observed percentages for the two groups relating to the specific characteristic were statistically different (H_A):

$$\begin{cases} H_0: p_A = p_B \\ H_A: p_A \neq p_B \end{cases}$$

19. This particular formulation of the alternative hypothesis H_A denoted that the test was a two-tailed test, meaning that an extreme value on either side of the sampling

distribution would imply the rejection of the null hypothesis.[4] Therefore the test rejected the null hypothesis if the proportion for one group of respondents giving a particular response was significantly higher or lower for than for another group.

20. The inputs to the calculation of two-proportions Z-test were:

(a) the proportion or percentage of each group of respondents giving a particular response to a survey question (eg those who said that the experience of the audit partner was an important consideration in the appointment of the auditor). We denoted these percentages as p_A and p_B respectively; and

(b) the respective achieved sample sizes for these two groups, n_A and n_B, ie the total number of respondents who were asked a particular question (eg the total number of individuals that had been asked what characteristic was important in the appointment of the auditor).

21. Using the observed sample characteristics, the value of the Z-test was then simply the ratio between the percentages' difference and the standard error:

$$z = \frac{p_A - p_B}{SE}$$

22. To compute the standard error *SE*:

(a) First, compute a pooled sample proportion *p* as a measure of the weighted sample average of the proportions of the two groups:

$$p = \frac{p_A n_A + p_B n_B}{n_A + n_B}$$

(b) Then, compute the standard error *SE*, applying an FPC to each group is given by:

$$SE = \sqrt{p(1-p)[\frac{FPC_A}{n_A} + \frac{FPC_B}{n_B}]}$$

[4] We did not implement one-tailed tests because we were not interested in knowing if a group of respondents has a greater or smaller percentage of agreement with a survey statement than another group.

23. A value of z is obtained by applying the formula given in paragraph 21 above. This must then be compared with the theoretical critical value corresponding to a 95 per cent level of confidence, that is z=±1.96. The null hypothesis is rejected whenever the estimated z value exceeds the theoretical z threshold in absolute value.

24. For example, let us consider question B3 and focus on the differences between FTSE 350 companies versus all other companies (following the above-mentioned notation, respectively groups A and B). The strength of international network was an important characteristic in deciding to appoint or reappoint a statutory auditor for 64 per cent (p_A) of FTSE 350 companies (with question sample base n_A equal to 195 companies) and for 45 per cent (p_B) of all other companies (with corresponding sample base n_B equal to 279 companies).

25. In this example, the pooled sample proportion *p* is equal to 0.52. The FPC for each group can be easily computed by means of sample and population sizes in Table 1. Combining these elements, the estimated standard error *SE* is equal to 0.034. Then the z value of the observed data is equal to 5.6,[5] much greater than the corresponding 95 per cent confidence level, z=1.96.

26. This meant that we rejected the null hypothesis that the percentages coming from the two samples were equal, meaning that there was a statistically significant difference (at the 95 per cent confidence level) between the two groups concerning auditor characteristic.

27. Conversely, if the null hypothesis of equal percentages would have been accepted because the z value was found to be less than 1.96, then we would have claimed that there was no statistically significant difference (at the 95 per cent confidence

[5] The calculation used to obtain the Z value, based on the given in paragraph 24, is Z= (0.64-0.45)/0.034 = 5.58.

level) between the two groups with respect to the strength of international network of the statutory auditor in deciding a (re-)appointment.

Responses to CC survey question B17

1. This annex reports the raw verbatim responses of FTSE 100 and FTSE 250 FDs/ CFOs and ACCs to the CC Survey question B17: 'You have told me that your company has not tendered its statutory audit in the last 5 years. Why is this the case?' We report the categorization of responses the CC has used: reasons for not tendering are categorized as positive, negative, mixed and other (see paragraph 57). Table 1 reports the number of each type of respondent to the question. Table 2 reports the responses for FTSE 100 respondents and Table 3 reports the responses for FTSE 250 respondents.

TABLE 1 **Number of respondents to CC survey question B17**

	FTSE 100	*FTSE 250*	*Total*
FD/CFOs	26	62	88
ACCs	27	49	76
Total	53	111	164

Source: IFF survey.

TABLE 2 **FTSE 100 responses to CC survey question B17: 'You have told me that your company has not tendered its statutory audit in the last 5 years. Why is this the case?'**

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
We believe quality and independence of the service we are getting is good.	FTSE 100 FD/CFO	1	0	0	0
We are very happy with the service and quality we're getting at the moment.	FTSE 100 FD/CFO	1	0	0	0
Changes in CFO and changes in audit partners meant that the audit approach has been regularly reviewed and challenged. It just means there's a fresh perspective brought to the old audit approach.	FTSE 100 FD/CFO	1	0	0	0
I know from talking formally to other auditors what price I could get. I also benchmark it against all of my peer group of companies, so I know the market price.	FTSE 100 FD/CFO	1	0	0	0
We've done a very thorough review of a/ the quality of service provided, b/ the performance of the audit partner and c/ the level of audit fees, and we've been fully happy with that.	FTSE 100 ACC	1	0	0	0
Satisfied with the service, satisfied with the fees which have been reduced by 40%, and satisfied with the quality and standing of the auditor.	FTSE 100 ACC	1	0	0	0
We haven't found the need to do it. We have a rigorous audit from [✂] and that seems to work quite well, but we recognise that we probably should do it in the next year or two.	FTSE 100 FD/CFO	1	0	0	0
Because, we got [✂] to re-pitch for the job with the understanding that if pitch wasn't satisfactory we would go out to others. We've been pretty happy with service we get.	FTSE 100 ACC	1	0	0	0
Because we have been very satisfied with quality and coverage of the audit we have had. The other challenge is the quality of the lead/ engagement partner who changes the course every five years. That's a more important decision for us.	FTSE 100 ACC	1	0	0	0
Because we rotate the audit partners every five years so we don't believe it is necessary to tender the audit. We are getting a high quality audit from the existing auditor.	FTSE 100 ACC	1	0	0	0
Because we have gone through a sustained period of major change where [✂] have been excellent with both sector and company knowledge.	FTSE 100 ACC	1	0	0	0
Our annual review of existing auditors and discussions with management and the audit committee have concluded that it is not needed.	FTSE 100 ACC	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Combination of reasons - quality and being satisfied, price satisfaction, changes internally, regulatory changes, most recently retail grocery code requirements where the auditors have to audit those submissions. With those changes internally, the questionnaires and benchmark, the continuity is more value than a forced change.	FTSE 100 ACC	1	0	0	0
Because we feel we are getting an excellent service from [✂]. Formally evaluating it every year, we are happy with the people that are on the audit, and we are constantly talking to [✂] about their ability. We think that could not be improved on by another firm.	FTSE 100 FD/CFO	1	0	0	0
We're satisfied with the quality of the work that the auditors perform, and we consider it annually. Taking all things together we don't believe there is a need to go out to tender, although we have had fee discussions annually and have seen a reduction in audit fees.	FTSE 100 FD/CFO	1	0	0	0
We have not seen the value in doing that. We have ensured that there is sufficient competition tension of current auditors both from the costs and performance point of view.	FTSE 100 FD/CFO	1	0	0	0
Because we are comfortable the service we are getting is a good service. We are very self-critical with ourselves and our auditors. When things are not right we look to put them right. If all those things are happening, then we don't feel the need to go out for a formal tender. Formal tenders are barely extensive gross as it takes up a lot of management time and it doesn't feel its a good investment of management time. If we are happy with what we are getting its in good shape.	FTSE 100 FD/CFO	1	0	0	0
Didn't find it necessary because the analysis that we have done showed a good deal from the incumbent and are satisfied. The experience and knowledge was absolutely essential from the firm due to rough time in the property market in the last 5 years.	FTSE 100 ACC	1	0	0	0
We are happy with the service we get from [✂]. We benchmark it against other firms on the costs and performance basis and services. There is a lot of infrastructure that we have in place that if it means we wanted to move auditors, it's just a matter of quality and price. To be quite honest, the big 4 all have good services and its making sure they have that specialisation in the industry, they need to have all those qualities as well as independence which [✂] do so that's why we have not changed.	FTSE 100 FD/CFO	1	0	0	0
We do a review every year and for the last five years and we've been happy to continue with the account.	FTSE 100 ACC	1	0	0	0
We're going through, or we've just gone through a change in engagement partner, which is in itself a change in its own right. We're very satisfied with [✂] performance. Those are the main reasons.	FTSE 100 FD/CFO	1	0	0	0
We are happy with the quality we have got. We benchmark the costs regularly. We deal with many other firms all the time at happen to see many of them better. When they last did a re-proposal internally, where we did not have external partners compared against them but none-the-less they went through a proposal - the audit committee were entirely happy with what they were proposing to do.	FTSE 100 FD/CFO	1	0	0	0
They are under constant review. If we were dissatisfied with them we don't need a five year rotation point, they're under consistent review. If we had issues with them we'd change.	FTSE 100 ACC	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Because, when we look at the criteria for appointment of auditor, we are satisfied that [✂] at least meet those criteria, and they're as strong as any of [✂] competitors. It comes back to the criteria and I think the main criteria are independence, quality of service, and that would be in terms of technical audit knowledge, technical accounting knowledge, industry knowledge and global reach, so knowledge of the environment in which we work. Then the last criteria is value for money and efficiency.	FTSE 100 FD/CFO	1	0	0	0
Because we are very happy with the quality of it.	FTSE 100 FD/CFO	1	0	0	0
Well, there was no reason to do it. We were satisfied with what we had and we'd commit pared to other companies and didn't think they would offer better value for money	FTSE 100 ACC	1	0	0	0
We are satisfied with our audit firm	FTSE 100 ACC	1	0	0	0
I think, firstly we receive very good quality of service so there is no cause to (tender). And secondly, we as an organisation have been through a huge amount of changes in the last five years and adding to that to going to attend a process would be to stretch the margin bandwidth and the current incumbent would not be appropriate anyway with it been 10-12 years	FTSE 100 FD/CFO	1	0	0	0
Because we have been satisfied with the fees from [✂]. Also the AIU public report shows [✂] has been the best performing of the top four firms.	FTSE 100 ACC	1	0	0	0
Simply because we get good quality service.	FTSE 100 ACC	1	0	0	0
We have been a very fast developing company with a vast geographic spread and a lot of time and effort has been spent in ensuring we have the right audit team.	FTSE 100 ACC	1	0	0	0
We tendered it six years ago, and a tendered process is very expensive, time-consuming and it takes an auditor three years to really get up to speed and understand the business.	FTSE 100 FD/CFO	0	1	0	0
A lot of change within the business, a lot more activities taken on, and therefore a degree of continuity for people to understand the business is quite important and a massive amount of change is also going on. So I guess, its a balance of having new people coming in that doesn't know anything about the business and at the same time there has been a lot of change going on in the business. So knowledge and a stable background which we would need to compare and consider the change.	FTSE 100 FD/CFO	0	1	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
I don't know as I have only been a Director since 2008. We have been Satisfied with the service with the auditor in our annual review of their service levels, and plus the cost and disruption and risk of changing an auditor in a major international bank is very high. cost and risk of change would be very high and we are satisfied with the auditor and have annual reviews, and we have what we think is completely adequate independence through change in the fact that the audit partner changes every 5 years.	FTSE 100 ACC	0	0	1	0
Essentially, we reviewed the performance of the auditors and we felt they were both very thorough and very independent. From the Audit Committee's point, we need to be sure that the audit will identify whether there are any weaknesses in the organisation, so that's what we were looking for, and we believe that the auditors have done a good job. So, having determined that, then if we had asked the other firms, who we know well from other places, to present, we didn't believe that that would result in us changing auditors, and in fact we'd probably be wasting everybody's time, and it's quite an expensive process. But, most importantly, changing auditors, we believe, is the time when you are potentially at biggest risk, because a new audit firm in the first couple of years is getting up to speed (with your company) and therefore we don't believe it's in the shareholders interests so long as we are satisfied with the job the auditors are doing. If you appoint a new firm of auditors, if you're an audit committee in the first year or two you would perhaps worry that they wouldn't be quite as close to the business as the previous firm. So, we would only change auditors if we were unhappy with the auditors that we've got.	FTSE 100 ACC	0	0	1	0
We certainly considered it, and then we took into account effectively factors such as the quality of service we were getting, and the effectiveness of the audit. We also took into account the management time and effort involved in the tender process and whether we would get any benefit from the tender process.	FTSE 100 FD/CFO	0	0	1	0
There's no need. The cost of transfer is high, the risks of change are also high. It's very difficult to identify value in change.	FTSE 100 FD/CFO	0	0	1	0
Because we've been satisfied by reference to our own internal and comparative enquiries that the quality and service provided by our incumbent auditors was adequate and, secondly , that the degree of disruption in making a change would more than outweigh any small advantage that there might be.	FTSE 100 ACC	0	0	1	0
Primarily continuity is very important. We're a complicated business and we use complicated financial instruments in our supply chain, and we find that the rotation of the partner is a very key event where we do get a refreshment of approach and people will bring their own experience and learning and focuses which means that we don't feel that we have a staleness. We're also moving quite significantly as a company - putting in shared service centres in Poland through one single computer system. That is a time when continuity of audit and understanding of what should be there is going to carry more value. We did consider this three or four years ago, whether we should go out to tender and we concluded that with myself being new and with the audit partner being new and with a significant change programme being ahead, that stability in the audit team while there was potential instability elsewhere was the best way to ensure the integrity of the audit.	FTSE 100 FD/CFO	0	0	1	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
There's only one other firm that can do what [✂] do. And if we ask them ([✂]), which we have, they don't want to do the audit because they get paid more money in terms of being independent. And actually, they would have to unwind all of their conflict issues, particularly, those in the US. So it is no mean feat for [✂] to be willing to come forward. The real protection is to ensure there is a 'tropper' and rigorous rotation of the partners on the account. They are high quality but they rotate regularly. For us it's not about the firm. If I was a small company only operating within the UK, I think there is much more choice of available to me. But I operate in 70 different countries around the world with no main market so - my largest market is 16% of the group - it's matching the footprint is the challenge. So, our protection and our quality control is to ensure that the partner rotation happens absolutely regularly and that the quality of the partner change is good.	FTSE 100 FD/CFO	0	0	1	0
We are satisfied with the quality of audit, and the disruptive effect of any audit change, and also the risks of audit failure on a change. There is a constantly evolving business, and constantly regularity continuity is important to ensure audit effectiveness. I refer to the introduction of socks and ifrs. These have a major impact on a business and having auditors with depth of knowledge of the business and of the audit risks is important. We are confident in the audit committee's ability to ensure independence and objectivity. The audit firm that we are currently with.	FTSE 100 FD/CFO	0	0	1	0
Firstly we've been successfully negotiating our audit fee down year on year; secondly it's a very competitive market in the sense that all companies offer a similar set of services; thirdly there's an enormous amount of organisational knowledge tied up in the audit partners in 180 countries around the world and you wouldn't want to change them overnight as it would substantially reduce the quality of the audit. Because the audit is quite a defined, technical specification the audits you'll get from all the four firms is roughly the same. Because it's a very competitive market in that sense and all the services are very similar it comes down to price, it comes down to the scale of the firm and the quality of the audit partner, so those are the three key criteria.	FTSE 100 FD/CFO	0	0	1	0
Because we carried a review on the benchmarking of fees and quality of service and felt that the likely benefit of changing auditor in relation to the cost and disruption of going to a tender and potentially changing auditor didn't justify it.	FTSE 100 ACC	0	0	1	0
Because we are satisfied with the audit service we get, with the coverage the firm has. There is also we believe that the knowledge the auditor gains over time of the company's operations makes it more efficient. Therefore a change in auditor is disruptive both in terms of efficiency - because of their relatively low level of knowledge of the sector and the company specifically in the early years creates a larger risk of audit error or unidentified errors. The more knowledge your auditor has of the business the more value they're bringing in terms of identifying risks and errors in the account.	FTSE 100 FD/CFO	0	0	1	0
The answer is we carried out our own assessment of satisfaction, we benchmark the fees periodically against other firms but we above all look at the quality of the audit work and are happy about that. There are considerable costs and risks associated with change and we believe that we have a high quality audit and the cost and risk of change is greater.. or has been greater than the current.. than the benefit of reviewing the position. That wouldn't necessarily last forever. It's something that we consider regularly.	FTSE 100 ACC	0	0	1	0
Because quality is of paramount importance and ultimately we have to make a judgement of the cost of a tender and change-out, not just the cost of a tender itself. First there is the erosion of quality it will bring versus the potential benefit in price that can be achieved. Price is not the predominant consideration in the choice of our external auditors, it is quality. An audit service is typically an area where longer tenure brings advantages and we have other means to negotiate the costs of the audit service.	FTSE 100 FD/CFO	0	0	1	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Because we are broadly satisfied with the service and I think it would be too disruptive to re-tender.	FTSE 100 ACC	0	0	1	0
It had a tender, it had a specific pitch from the incumbent but the reason it didn't was we've been having some very, very significant system changes taking place over the last three to four years and it seemed not an ideal time to change auditors. Some big, big new systems going in to the group. Yes, very significant new systems so it didn't seem a particularly good time to contemplate changing the audits. Yes.	FTSE 100 ACC	0	0	0	1
I think over recent years there's been a trend in large companies not to see much differentiation among the big 4 and what they offer, nor have they been particularly active in trying to promote non audit services to audit clients. I don't think there was much incentive or market practice to encourage regular audit tendering, and there was no pressure from shareholders either.	FTSE 100 ACC	0	0	0	1
Because we changed auditors to be.. when the company went public and we haven't felt it appropriate since then to change. We probably will review it in the next two years. Yes, mainly because we think we ought to. We think they're a service provider like anyone else and every now and then, we should go out and tender. One or two factors. One is to ensure continued independence, two, a fresh set of eyes and three, to keep a competitive and challenging relationship.	FTSE 100 ACC	0	0	0	1
Due to regulatory uncertainty I don't think now would be a sensible time for any company to put its audit out to tender. Regulatory uncertainty can actually trigger a lot of inactivity. To change now would not be sensible, because if a new set of rules comes in you may have just spent a lot of money on something you then have to change all over again.	FTSE 100 FD/CFO	0	0	0	1
The company is still new, we're two years in the making.	FTSE 100 ACC	0	0	0	1
A merger took place in 2000 and [✂] was the auditor for one and [✂] were for the other, but the management of the group decided to appoint [✂] without a tender but I don't know why they did that as I wasn't there at the time.	FTSE 100 ACC	0	0	0	1

Source: IFF survey.

TABLE 3 **FTSE 250 responses to CC survey question B17: 'You have told me that your company has not tendered its statutory audit in the last 5 years. Why is this the case?'**

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
The company was only formed in 2007, so our current auditor is our first and only auditor. We're quite happy with the fit and quality of the service.	FTSE 250 FD/CFO	1	0	0	0
Happy with the existing auditor and we thought the fee was competitive.	FTSE 250 FD/CFO	1	0	0	0
I think it's just that we've been very happy with the service that we've received from [✂], so we've not considered it necessary.	FTSE 250 FD/CFO	1	0	0	0
It's been about service. We haven't considered a need to do so. There's been no need to change. Any issues on service have been satisfactorily addressed. We had certain issues with auditors and we had the potential discussions for tender on the agenda recently in the last 2-3 years, but these were addressed and the company has been going through re-financing in the last few years in one form or another, in order of priority we find an audit tender can be quite disruptive. Our finances take priority.	FTSE 250 FD/CFO	1	0	0	0
Because we have not felt the need to. We have rotated the partner, we get from our auditor what we need from our auditor and we feel that they are the best in the market.	FTSE 250 FD/CFO	1	0	0	0
We've carried out a thorough review with our existing auditors and concluded that we would not make a change. We keep it under review but we satisfied ourselves a year ago.	FTSE 250 FD/CFO	1	0	0	0
We did not consider it necessary as we were satisfied with the audit and the service we were getting in terms of quality, efficiency and cost.	FTSE 250 FD/CFO	1	0	0	0
We have been very happy with quality and the advice given by the lead audit partner who we hold in the highest regards, and we have been happy with the quality and reporting of our auditors.	FTSE 250 FD/CFO	1	0	0	0
We are a big group with many subsidiaries. We looked into how often other companies change and it's not that often, especially in the UK. Secondly, to get new auditor to tender is going to take a lot of investment and time from the auditor's side and the management side. Its going to take so much of our time and time is important these days. We are also getting good value from [✂]/ good advice, and we are happy.	FTSE 250 FD/CFO	1	0	0	0
We believe we've got good quality service, really good quality team. They are incredible keen to deliver excellent service and they make sure they're competitive on price.	FTSE 250 FD/CFO	1	0	0	0
There hasn't been the need to. The directors that sit on the audit committee and also the wider board sit on similar other investment trusts which aren't managed by JP Morgan, so they're aware of service levels received from other audit firms.	FTSE 250 FD/CFO	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Because we are satisfied with the quality of the audit work.	FTSE 250 FD/CFO	1	0	0	0
We have audit partner rotation and this keeps the process fresh - so we think that's the principal reason. We're getting a new pair of eyes on the audit as a consequence of that happening. Over-riding all of that during this period we have been satisfied with the service we have received from [✂].	FTSE 250 FD/CFO	1	0	0	0
All the benchmarking leads us to believe we couldn't achieve additional value or cost savings by using another firm. Also, we work hard with our auditors to improve efficiency, so we task them with mitigating the impact of inflation on their audit fee by gaining efficiencies elsewhere. That's a two-sided process, so it's about us providing the auditors with the right information in the right form and also developing a risk based approach to the audit. To do that, you need an auditor who understands your business and where the key risks are in your business from a reporting perspective. If you change auditors every few years, you lack that comprehension of the business, and hence audit fees are likely to rise.	FTSE 250 FD/CFO	1	0	0	0
Very pleased with the service we've had from [✂] and we feel we're getting good value at a competitive price. But, we are at a point of considering reviewing that appointment probably over the next year or so.	FTSE 250 FD/CFO	1	0	0	0
Mainly because we're happy with the service we get, and the informal benchmarking we do on price, metrics of gross margins and revenue, compares quite favourably with competitors. So, we don't think there is a cost-driven reason to do it and the service is pretty good.	FTSE 250 FD/CFO	1	0	0	0
Because we've always concluded that we're very happy with our existing auditors.	FTSE 250 FD/CFO	1	0	0	0
We feel we get good value for money from [✂].	FTSE 250 FD/CFO	1	0	0	0
We've been happy with the incumbent people/ existing team. They provide a good service and the fees have reduced year on year over the last 5 years.	FTSE 250 FD/CFO	1	0	0	0
We haven't done formal tenders, but we've done reviews with input from other firms to test the market and concluded that a formal tender is not needed. The formal tender process is incredibly time-consuming for all the firms involved and for all the companies and we know enough about the services and the choice that we've got to know what the conclusion is likely to be.	FTSE 250 FD/CFO	1	0	0	0
Satisfied with the quality, cost-effectiveness, efficiency, standards, independence, integrity, international reach, staffing, professionalism, other services, relationships, diligence, outputs and audit reports that we're getting from the existing incumbent.	FTSE 250 FD/CFO	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
We can't see benefit. Management time is better directed looking at other matters / not the auditors.	FTSE 250 FD/CFO	1	0	0	0
Because we are in regular contact with the big four, we monitor their capabilities in our business sector. At the time of the last tender were satisfy with [✂] to audit.	FTSE 250 FD/CFO	1	0	0	0
Because the quality of service we've been getting is sufficiently good that we don't feel we need to commit the time and expense of a formal tender process. So, the main issue is we're not unhappy with the service we've been getting.	FTSE 250 FD/CFO	1	0	0	0
We've always been satisfied with the service. An efficient process and good quality feedback. Also, good knowledge and experience of the sector.	FTSE 250 FD/CFO	1	0	0	0
Happy with the audit service being provided. We feel that the rotation of partner has ensured that we get appropriate independence.	FTSE 250 FD/CFO	1	0	0	0
We are happy with the service we've been getting.	FTSE 250 FD/CFO	1	0	0	0
We are happy with the auditors, happy with quality cost, delivery, the efficiency. At this time we don't see the enhanced value of going out to tender.	FTSE 250 FD/CFO	1	0	0	0
We are happy with service we are getting and we able to benchmark the price and the price is competitive.	FTSE 250 FD/CFO	1	0	0	0
We are comfortable and happy with the quality of the services provided by [✂].	FTSE 250 FD/CFO	1	0	0	0
Because we are satisfied with the current incumbent.	FTSE 250 FD/CFO	1	0	0	0
We are happy with our annual process of assessing the quality and cost effectiveness of existing auditors.	FTSE 250 FD/CFO	1	0	0	0
Because we don't have a particularly complicated group structure and [✂] have sensible people in terms of their experience and knowledge at the top end. We haven't felt the need, we felt that we were getting value for money I suppose. There is suitable amount of challenge and there is a constructive relationship.	FTSE 250 FD/CFO	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Not felt the need in terms of service quality or cost which would be the two reasons to tender.	FTSE 250 FD/CFO	1	0	0	0
We've had no requirement to, and we get the service we require from our auditors currently, in terms of knowledge, experience, continuity of the team and the quality of the audit review. It can't be replicated in terms of [company] group.	FTSE 250 FD/CFO	1	0	0	0
We think the relationship works well with [✂] who we've got. We get a good price. We have been rotating the audit partners so there hasn't been a need to change. When you have got a good firm and there's a continuity, it leads to a more effective and efficient audit.	FTSE 250 FD/CFO	1	0	0	0
We haven't felt the need in terms of the service we are getting and price we were paying. Also the senior staff in the audit team have rotated which has refreshed the team and approach which we are happy with.	FTSE 250 FD/CFO	1	0	0	0
We believe our auditors are doing a good and challenging job, that's not my view that's the audit committee's view. We benchmark the pricing against others annually. We look at costs, complexity of our business etc etc. So we at this point in time believe we are getting value for money although we wouldn't share that with them.	FTSE 250 FD/CFO	1	0	0	0
We have an annual process of reviewing our auditors in terms of quality and cost. We have also have rotation of senior partners in the last five years. These things have given us confidence that were getting good quality audit and good value for money and good independent audit at the moment.	FTSE 250 FD/CFO	1	0	0	0
Because we've got a good team of people on the team for the audit. The partner meets the criteria for knowing the sector etc. and we've been able to agree what we believe are the right level of fees through our benchmarking.	FTSE 250 FD/CFO	1	0	0	0
I think we've generally been happy with the service that has been provided, the individuals that are involved and their ability to cover our international business. Therefore, we haven't felt it necessary to go outside to a tender process.	FTSE 250 FD/CFO	1	0	0	0
We haven't seen it as an important thing to do. We've been satisfied that the service provided has been good and we get different audit partners who challenge things so it has not been a priority. We haggle the fee but we have not gone to formal tender, we are planning it in the next 12 months.	FTSE 250 ACC	1	0	0	0
No need. We're happy with the auditors level of expertise, fees, knowledge and they rotate the audit partner every five years, so we get the level of independence.	FTSE 250 ACC	1	0	0	0
Well we're satisfied with what we've got.	FTSE 250 ACC	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Not required. We don't. We're not. We haven't had any cause for concern that would cause us to require another firm.	FTSE 250 ACC	1	0	0	0
We were very satisfied, in the last 5 years? A full tender? Satisfaction, complete satisfaction with the way the audit was being conducted but requiring them to do a full tender to enable discussion, exploration in greater depth than the annual review of the list of factors I've given you when you asked what were the factors that you. What are the important points when conducting a tender and important in that, which you've got logged, I think, is independence procedures i.e. rotation of partner and the internal checks that are made on their own work.	FTSE 250 ACC	1	0	0	0
We're very happy with [✂] performance.	FTSE 250 ACC	1	0	0	0
We conducted a full review of the service that we were getting from [✂] and the service they were going to give us going forward.. A review of what they were proposing going forward and we were very comfortable with reappointing [✂].	FTSE 250 ACC	1	0	0	0
Because we're satisfied with them.	FTSE 250 ACC	1	0	0	0
Well, we're a, very happy with quality of audit. We place.. I place some considerable value on the knowledge the audit team have of the company. And as ever.. The technical quality of the audit team, you know the technical expertise of the audit team is very strong. Oh, I suppose I should say finally that we do not believe that fees are out of line with comparable organisations.. we think the audit fees are not out of line with comparable companies' fees - that's probably about it, really.	FTSE 250 ACC	1	0	0	0
We have never felt the need to do this. We are a self managed trust. Most investment trusts will appoint independent fund managers to manage the fund for them. These independent fund managers might be F&C Asset Management or Invesco or one of the big asset management companies. We're different. We're one of relatively few who employ managers directly - the investment management staff, the company secretary and others are direct employees of our company. Therefore it's quite hard to make a comparison between what the trust would pay an auditor and what we do because there's more work to do for us than there would be where the management is handled by a third party. We are quite satisfied over the quality of what [✂] does. The Company Secretary is certainly very satisfactory. We're not entirely satisfied - there have been one or two little incidents where the Company Secretary has been concerned about the way things have been handled - but nothing seriously. We think that the fees they charge us are fair by reference to the nature and size of the company we are. We've not really had cause to go out to tender. In my experience audits go to tender where there is some element of dissatisfaction. It would not be just as a matter of course.	FTSE 250 ACC	1	0	0	0
We're very happy with the performance from [✂]. No issues with them. We're happy with the team and their performance. They're very cost competitive, they have a good quality team.	FTSE 250 ACC	1	0	0	0
Because we are perfectly satisfied with the service we're receiving already and we have no reason to suppose anyone else would do a better job.	FTSE 250 ACC	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
We're satisfied with the services being provided with our current auditors, there would have been a change of audit partner, but there hasn't been a reason to change auditor. There is a reasonable perspective given by the audit partner.	FTSE 250 ACC	1	0	0	0
We are happy with the auditors. They changed the audit partner and as a result we have got a better audit partner. They also changed the audit manager and reduced their fees,	FTSE 250 ACC	1	0	0	0
Because we have been happy with the performance of [✂] and with the level of audit fee from them.	FTSE 250 ACC	1	0	0	0
Happy with the audit quality so far but that doesn't mean we would not retender in the future.	FTSE 250 ACC	1	0	0	0
Because we're very satisfied with our current auditors. Immensely, I mean I've been a Finance Director and recognise that.. [✂] do a good job for [company]. The relationship's strong and they're highly objective.. Is good.	FTSE 250 ACC	1	0	0	0
Because [former audit partner] as an individual was a tremendous audit partner. We enjoyed his quality of observation about all sorts of issues. Not particularly the auditing issues, wide observations about the industry and about us, about our performance fees, all sorts of things that we had done. We valued that enormously and [current audit partner] looks as if he will be of the same calibre. The fact that it's [✂] is irrelevant to us, it's the individual. We have plenty of time.	FTSE 250 ACC	1	0	0	0
Do you want an essay on that? How can I help you by being brief? Because our audit partner is rotated on the audit every 5 years and therefore you have a new auditor every 5 years and because we do as we answered to an earlier question, seriously review the performance of the auditors every year and satisfy ourselves as to the quality and value received.	FTSE 250 ACC	1	0	0	0
Because we are very satisfied with the service provided by [✂]. We negotiate every year with prices and negotiate on fees and they co-operate very well. We wouldn't do better elsewhere based on quality of service and price being charged. We don't want to take another firm on to get educated to know everything about us. We do though, and their regulations require, that the lead partner at least, be substituted and that has happened once already.	FTSE 250 ACC	1	0	0	0
We're satisfied with the auditors, and we review their work upon change of the engagement partner.	FTSE 250 ACC	1	0	0	0
We've been satisfied with performance and quality and therefore have proposed re-appointment. As we are growing internationally we value the relationship that has developed, which means the auditor has an understanding and perspective that's built on year to year.	FTSE 250 ACC	1	0	0	0
We're happy with [✂] and they're challenging.	FTSE 250 ACC	1	0	0	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Because they're happy with the service that's being provided.	FTSE 250 ACC	1	0	0	0
We're satisfied with the current auditor.	FTSE 250 ACC	1	0	0	0
There's no need. We get high quality audit and good value for money [from our current auditor], and changing auditors is expensive and risky.	FTSE 250 ACC	1	0	0	0
Because this company was demerged - created five years ago. We have had the partners changed but not the firm as such. That's how we saw it - spend some time with us to understand us and they are doing a good job.	FTSE 250 ACC	1	0	0	0
Because we've generally been happy with the service that has been provided, the individuals that have been involved and their ability to cover our international business. Therefore we haven't felt it necessary to go outside to run a tender process.	FTSE 250 ACC	1	0	0	0
Because we have the annual assessment and we are and the board is happy.	FTSE 250 ACC	1	0	0	0
We've got a good relationship, they deliver what we need. The fee seems sensible. Above all that, the hassle and effort involved I'm not sure would warrant the fees saved.	FTSE 250 FD/CFO	0	0	1	0
It's a huge trauma to the organisation to change auditor, so unless there's a good reason to do it, then we wouldn't undertake the task. So, we have to satisfy ourselves that the auditor remains competent and cost effective, and we do that by contacting other firms and we satisfy ourselves by virtue of working with the auditors in terms of competency. So, it is a big deal; it's a lot of effort, and a lot of costs to change, so there must be drivers to do it. You can try to beat down these people on price, but if that means you don't get the quality of the staff then that's a problem. So, to choose between four who can operate on a global basis is fine. Once you get to the tier below the 'big four', in my experience, they cannot operate in such a way to do a proper audit for a business like ours. So they are a long way off, and it would be problematic if there were less than four to choose from.	FTSE 250 FD/CFO	0	0	1	0
We did look at it about three years ago in a formal manner, but didn't go out as far as tender. We changed nine years ago and just didn't want to change again at that stage.	FTSE 250 FD/CFO	0	0	0	1
We reviewed it after five years and decided to extend it for a further year and review it at the end of that year, as well as some specific internal reasons.	FTSE 250 FD/CFO	0	0	0	1

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
Because we get excellent service from [✂] and we think it's good value for money. The other reason is tendering and changing auditors, which I've done three times in my career as a CFO, is an incredibly expensive and disruptive process. It's expensive in terms of time and the money it incurs and it's disruptive and takes probably two years for new audit team to get really up to speed and familiar with our business and really understand both our financial systems processes control as well as our operating business and our business model. So, it's incredibly disruptive and it's not something you do lightly. If it's working well and you're happy with it, and there's the right level of challenge, efficiency, advice, no significant issues, personalities fit, it's something you do not want to undertake lightly.	FTSE 250 FD/CFO	0	0	1	0
Because we're satisfied with the current relationship and feel that a new firm of auditors would not bring an improved quality of audit and would require more work bringing them up to speed with the sector. No expectation of a material difference in price but costs of efficiency.	FTSE 250 FD/CFO	0	0	1	0
It's a matter of 'if it ain't broke don't fix it'. In our experience differences between firms are much less significant than differences between audit partners, so there are times when the engagement partner must stand down after a certain period and you will get another partner with the same firm and the experience can be very different. It's not about the firm as much as anything, it's about the relationship with the partner; their mindset and their approach to the work. It's fair to say we've been lucky with the engagement partners' with our current auditor, all of whom have worked. So, it's all about people and personalities, it's not about firms. We've always been happy with the firm and always been happy with the success of partners with whom we've worked.	FTSE 250 FD/CFO	0	0	1	0
Because we've only existed for two years. The company was formed on a demerger two years ago.	FTSE 250 FD/CFO	0	0	0	1
No particular pressure to change and a limited choice of alternatives.	FTSE 250 FD/CFO	0	0	1	0
We've considered it, but we've just had a lot on buying, selling and building, so we've not been able to embrace that sort of change in our plans.	FTSE 250 FD/CFO	0	0	0	1
Satisfactory audit performance, efficient working relationships and perceived cost efficiency versus the aggravation and business disruption to move. It's a huge disruption to change auditor and when it's seemingly working well, there has to be a compelling reason i.e. relationships have fallen out or we're so far out on costs or something, to push us to impose that disruption on the business.	FTSE 250 FD/CFO	0	0	1	0
I can't speak historically for my predecessors. Given I've been in less than a year it's one of the things to look at but it's not at the top of my list.	FTSE 250 FD/CFO	0	0	0	1
Mainly because the company has been going through so much change and transition itself that adding the burden of changing auditor was certainly deemed to be an unproductive and unprofitable exercise. The company is being restructured, so changing the audit was just a step too far.	FTSE 250 FD/CFO	0	0	0	1

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
There is a complication, whilst we had a formal tender process after about three years with that relationship we couldn't agree on price and changed auditors without a tender process.	FTSE 250 FD/CFO	0	0	0	1
We've reached decision informally. Matters discussed with other firms and our existing auditor we believe is appropriate having considered alternatives. We've done the tender informally rather than formal tender process.	FTSE 250 FD/CFO	0	0	0	1
Good point - I would say the disruption caused is likely to outweigh the benefits gain.	FTSE 250 FD/CFO	0	0	1	0
We were a private company effectively. We were listed in 2010 and we had the choice of changing audit firm or audit partner so we wanted the continuity of the firm given we were newly listed. But we were very unhappy with the partner, which is why we changed him.	FTSE 250 FD/CFO	0	0	1	0
We thought about it on a couple occasions we were going to do a major merger last year and we were going to do retender on the back of that but the merger didn't happen. We are in the process now of doing major merger and acquisition and so we don't want to change auditors in the middle of that but we will look at it once completed.	FTSE 250 FD/CFO	0	0	0	1
I think we have been pretty content with the service we've been getting. Also the auditors rotate their audit partner, so we are getting a fresh look on a fairly regular basis and that does reinforce the independence of the audit. Corporately, we've been through a period of quite a lot of change, merger companies etc - occupied about five years ago - and that has introduced a lot of complexity into the way the accounts are drawn together where the history is quite important for doing the audit effectively. Bringing a new firm in would have been pretty painful in terms of the amount of time it would have absorbed. Those are the main reasons. We went through a major corporate re-organisation in 2007, substantial inflow of new directors, so we feel we have been with our auditor for about a five year period. That's not to suggest we won't go out in the best interest of having a formal look outside and good corporate governance.	FTSE 250 FD/CFO	0	0	1	0
Because one of the most important things for a successful audit is a period of acclimatisation to the company, making sure they understand how the business operates in various corners of the world is massively important to have an efficient and effective audit. Chopping and changing all the time would be incredibly inefficient and would lead to increased audit risk. We have had rotating partners on the audit instead, and that's it.	FTSE 250 FD/CFO	0	1	0	0
Yes, so we've had the same auditor for five years and that's since conception.	FTSE 250 FD/CFO	0	0	0	1
In the last five years that we've just being going through considerable change, it would be very risky to make an audit change at the time of considerable group change. It's growing rapidly through acquisition.	FTSE 250 ACC	0	0	0	1

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
If you think that the firm that you use.. OK, the reason is that it takes any of the big four, and the same would apply to anybody else, it takes them a year to write up a permanent file and to really begin to understand the basics of the business, in the second year they build on that knowledge, they understand it a bit better, they identify the errors in their initial assessment. By about the end of year three, they begin to really know what they're talking about and you fix the partner for five years. If one kept switching firms, you would have a complete loss of knowledge, and absolutely you would have a loss of thoroughness of audit, and so by having one firm do the audit for many years, you get a more.. there is a greater depth and knowledge in that firm about [✂], there is a more rigorous thorough audit and at the end of the day, as the audit committee chairman, I am most interested in a vigorous, thorough audit and, to have to change firms, for instance every five years or nine years, I think would be disastrous. Frankly, if it doesn't work with a firm for some odd reason, you'd want to change quicker than that, On other other hand, if there's a good working relationship, then there's no reason why you shouldn't have them continue to have them supply a service for many years, but I think you should go through a rigorous process every ten, fifteen years, yes.	FTSE 250 ACC	0	1	0	0
Because, in my humble view, and the view of the audit committee, it's the auditor and the audit team, which is six in the case of [✂] and we rotate the audit partner, or the audit partner has rotated every three years so it's people, not the firm.	FTSE 250 ACC	0	0	0	1
Because tendering an audit is hugely disruptive in terms of management time. We have also done some major acquisitions so last thing you want to do is to put an audit out to tender. The other point is that there is actually little to choose between big firms and the most important thing from my perspective is that we have an audit partner with the right stature and experience.	FTSE 250 ACC	0	0	1	0
We haven't seen the need to do so.	FTSE 250 ACC	0	0	0	1
Is this a verbatim one? OK. We originally appoint.. We previously had another big four firm. We changed about 6 years ago and gave [✂] the full term of one partner, that is five years. We have now changed partner and will re-tender once we have enough experience of a new partner's performance. So, we did not want to change partner and auditor at the same time.	FTSE 250 ACC	0	0	0	1
We listed on the stock exchange 5 or 6 years ago, so are fairly newly listed, we also had quite a few acquisitions, we felt the combination of those things and also rapid growth meant we had enough on our plate without getting a new auditor. Because of rapid growth and we were newly listed and didn't want a disruption to that which could be caused by the tender process and change of auditors.	FTSE 250 ACC	0	0	1	0
Happy with the auditors - they remain cost competitive and because changing the auditors involves a lot of incremental work for managers. You think of the stress for the organisation.	FTSE 250 ACC	0	0	1	0
I think you need sensible approach to the auditors becoming an integral part of the way in which the audit is carried out over several years. In my view 7-10yrs is too frequently, seeing as the auditors are rotating partners and members of their team anyway so you don't need to do it that often.	FTSE 250 ACC	0	0	0	1

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
it's only been a separate standalone company for 2 years	FTSE 250 ACC	0	0	0	1
For statutory audit services, we haven't.. we've made the decision each year for the last nine years to reappoint the auditors. What we did do was to appoint [✂] as our internal auditors as opposed to our external auditors, which was about 5 years ago but we haven't.. we have each year chosen to go to the AGM with a proposal to reappoint the auditors and that's since 2003. We've felt very comfortable with [✂] and we've used.. we're perfectly satisfied with [✂] service and we feel comfortable we know how to benchmark it. I mean there is an element here that the industry is quite an esoteric one and a change in auditor would require a great deal of disruption. [✂] Not interim. [✂], we have appointed them as our internal auditors. So we've.. we'll put it differently. We out-source our internal audit to [✂] so in that sense they are an outsourcing agent, which obviously means that they're permitted to doing some things as are [✂] in doing some things. It's partly because of [the esoteric nature of the business]. It requires specialist knowledge. Sorry? Both, you need a partner that understands the business and he needs to be supported by a team that understands the business.	FTSE 250 ACC	0	0	1	0
We've carried out the quality review procedures that we have.. That I've explained and we do.. we've changed the partner and made sure that we have an independent and refreshed approach and more industry knowledge through changing the partner so we've had team changes to refresh the independence and perspective but we do value their knowledge of the business and regard that the balance of.. we have a refreshed team and we regard that as giving us independence but their, the firm's overall knowledge of the business we regard as valuable so the overall benefits of change are minimal or, in fact, could be negative.	FTSE 250 ACC	0	0	1	0
After four years the CFO resigned and we were going to put it out to tender to another firm as well as [✂], but as the CFO had resigned, I was not prepared to put it out to tender as a new CFO was coming in.	FTSE 250 ACC	0	0	0	1
I think it's because the company was de-merged about four years' ago and at that time the audit arrangements were reviewed and effectively [✂] were appointed for [company] as a standalone company.	FTSE 250 ACC	0	0	0	1
We've been happy with the service we've been getting. It's interesting actually. Last year, we did have a very detailed discussion about whether we should take it for tender because the audit partner was rotating off and we thought that may be an appropriate time to look at other firms and we decided, after a lot of discussion, we decided that we would not this year partly because there's so much in the melting pot. You know the FRC are looking at a requirement to put it out for tender and Europe is looking at a requirement to put it out for tender, so we thought we'd wait another year at least.	FTSE 250 ACC	0	0	0	1
I wouldn't expect a firm to audit more frequently than every 5 years. It's also been.. If you think over the last 5 years, there's been a very turbulent time in any event but I wouldn't, frankly I wouldn't expect a firm to tender the audit more frequently than every five years, and possibly every seven. Various reasons. There is a benefit in having the audit team build experience and knowledge of the company in order to perform their tender properly and to change your auditor too frequently undermines that and creates cost and inconvenience for the company and the audit firm.	FTSE 250 ACC	0	0	1	0
Not a big priority because the auditors are doing their job. Not enough time to put effort on it. No necessity to spend the time and effort on it and its only been a public company for 5 years.	FTSE 250 ACC	0	0	1	0

Response	*Respondent position*	*Positive reasons*	*Negative reasons*	*Mixed reasons*	*Other reasons*
We haven't felt that the benefit outweighs the disruption and cost and we are satisfied with the service we are getting from our existing auditors. It's a very disruptive process to change auditors.	FTSE 250 ACC	0	0	1	0
It was a private company until two years ago and the best standards of corporate governance were not the driving factor. Low-cost, efficient audit was the priority rather than the full range of good governance factors which would be taken into account by a listed company, which it now is, and are now relevant. It was previously a private company and for the last two years it's been a listed company and it is in the process of changing its stance towards its auditors.	FTSE 250 ACC	0	0	0	1
The company was incorporated in 2005. Therefore, it is not appropriate to invite a re-tender.	FTSE 250 ACC	0	0	0	1

Source: IFF survey.

Responses to CC survey question C5

1. This annex reports the raw verbatim responses of FTSE 100 and FTSE 250 FDs/ CFOs and ACCs to the CC survey question C5: 'What impact did switching auditors have on internal costs? By internal costs I mean management or staff costs, or other operational costs.' This question was asked to respondents at companies that had tendered in the last five years. Table 1 reports the responses for FTSE 100 respondents and Table 2 reports the responses for FTSE 250 respondents.

TABLE 1 **FTSE 100 responses to CC survey question C5: 'What impact did switching auditors have on internal costs? By internal costs I mean management or staff costs, or other operational costs'**

Response	*Respondent position*
Significantly large. It was higher.	FTSE100 FD/CFO
Not significant. You can't put a price on it. You know, to switch, there was a logistical effort. It has to be planned and controlled, but it's eminently doable. I'm not even going to try and tell you what the opportunity cost was 'cause I've no idea what it was, but it's not significant. Little additional costs.	FTSE100 FD/CFO
Well, I can't put a number on it, but there was some extra in terms of learning time for learning while we had to give up our time while they had to get up to pace, so there was some extra time and resource. I wouldn't want to put a number on it, but there was extra time and resource. It was transitional costs.	FTSE100 FD/CFO
Probably no difference.	FTSE100 FD/CFO
Well, there was some significant additional management time and effort associated with managing the tendering process and there was probably a significant addition of time and effort in the first year of the new audit because we had to spend a lot more time explaining to the audit team how the systems worked, the controls worked and how we put the numbers together. Following years, I would say that there was no significant change from the time and effort and cost that there was in an average year for the prior audits.	FTSE100 FD/CFO
None.	FTSE100 FD/CFO
No impact. I'd be surprised if there was any impact.	FTSE 100ACC
Well, in terms of going out to tender, it is a cost to the organisation 'cause the senior management and the finance management have to spend good periods of time with each set of auditors that are going to tender, so there is a cost to the organisation of going out to tender. Once one's made that decision, I don't think there's an increase in internal cost. But, equally, there's no reduction. Well, as I said, I think it's very important as people move down the route of saying 'well, everybody should go out to tender every four years or five years', an important factor should be disruption to the organisation when you go out to tender, 'cause it does cost time when you go out to tender because the internal people - and, mainly, it's the critical, senior people - have to spend a good deal of time with each audit firm that's going to tender, so that is a significant cost. Once the tender decision's made, probably there's no impact one way or another on internal cost. They were higher when the tender process was in place.	FTSE 100ACC
We actually spent more on internal assurance because I think, just to assume a discount and get lower hours, means you're not getting the same level of audit. No, it's remained so. It sort of...we've increased the number in internal audit. If you take a figure, if we had a third reduction, you've got two choices there. It would either mean that [✂] were going to lose a third of their money, compared to [✂], or they were going to do less hours, and many companies just take a discount - and I understand the discounts in the market at the moment are about forty-five, fifty percent - that's fool's gold. So, what we did, we spent more on the internal assurance, but we've hit lucky because [✂] have put in the same hours that the previous firm did in the first year and the second year, and plan to do so again.	FTSE 100ACC
Minimal extra so, effectively, nothing.	FTSE 100ACC

Source: IFF.

TABLE 2 **FTSE 250 responses to CC survey question C5: 'What impact did switching auditors have on internal costs? By internal costs I mean management or staff costs, or other operational costs'**

Response	*Respondent position*
We've increased costs internally, only because some of the savings which were delivered as part of the audit tender process we've invested in other internal assurance procedures. So, the audit itself hasn't had a direct cost on internal costs, but we've just decided to invest more in certain areas. That was planned.	FTSE 250 FD/CFO
Not applicable [this was their first and only auditor as the company is young]	FTSE 250 FD/CFO
It went up in the first year, and has reduced after that. Reduced below where we were previously.	FTSE 250 FD/CFO
I think, in the overall scheme of things, quite limited. This is not specifically for [COMPANY NAME], but my experience of switching auditors has been that the process of tender, if done properly, can be quite time-consuming for management because, typically, if you're bringing three or four firms in to tender, management have got to meet with, and brief, three or four firms. But, once you actually make the change, I think the learning curve is much more for the auditor than it is for management.	FTSE 250 FD/CFO
None at all.	FTSE 250 FD/CFO
I would say, for the first year, they were probably higher, but that was really part of the learning curve. [Asked by interviewer if costs decreased in the following years] Yes, they would have done.	FTSE 250 FD/CFO
None, really.	FTSE 250 FD/CFO
Difficult to measure, but it's quite disruptive. I mean, it's not necessarily a straight pounds and pence thing but a disruption of people. You know, more interview time, etc, etc. There is a cost attaching to people's time. It was higher in the first year and then they just revert back, but it didn't go lower, I can assure you. It's just higher in the first year and then the same afterwards. You get a bubble of switch, so you probably haven't got the box. There is a cost to it, so if people are saying this is a low cost thing, it's not. It's very disruptive, so you wouldn't want to do it often.	FTSE 250 FD/CFO
Well, we don't do detailed costing. We're a smaller firm than that. We don't do sort-of timesheets or anything of that nature and I think your first point; it's difficult to distinguish here between the natural evolution of the company - which has sort-of doubled over the last few years - and the specific impact of the audit firm. I think I'd turn around and say: there's a one-off effect where there's an education process to be gone through, but that was efficiently handled by the auditors - as efficiently as they could do, I would say - and, since then, because we're dealing with people that are competent, it's been quite smooth. No real impact.	FTSE 250 FD/CFO
I'm not sure that there was material impact on internal costs. I suppose you could probably turn around and say that there was some reduction because you spend less time having to sort the auditors out, you can spend more time running the business.	FTSE 250 FD/CFO
Well, it was time-consuming, both going through the tender process and then the selection process, and then there's the briefing of new audit teams, both centrally and in the operations, including overseas operations, so there is an amount of management time that gets used up as a consequence of the change. Direct additional costs of changing audit? Nothing, other than people working a bit harder to accommodate it.	FTSE 250 FD/CFO

Response	*Respondent position*
None.	FTSE 250 FD/CFO
They would have increased, albeit they would have been hidden in terms of, not actually extra costs, but in terms of management time. When you change auditors, there's always quite a lot of investment in terms of getting people to understand the business, so there is a cost impact. The cost would have gone up.	FTSE 250 FD/CFO
Don't know, sorry.	FTSE 250 FD/CFO
Minimal. I would say it made no difference, really.	FTSE 250 FD/CFO
No change.	FTSE 250 FD/CFO
No impact.	FTSE 250 FD/CFO
Well, initially, put them up because of increased management effort, and probably settled back to a similar level after that.	FTSE 250 FD/CFO
It was painful in the first year so, I mean, it's just a question of time, really. So, the first year we spent an awful lot of time with the audit team. We have refined the process over the three years that they've been internal auditors.	FTSE 250 FD/CFO
No cost impact, but a time impact in terms of people getting the new teams up to speed.	FTSE 250 FD/CFO
Not applicable [this was their first and only auditor as the company is young]	FTSE 250 FD/CFO
Insignificant.	FTSE 250 ACC
I think there has been an overhead associated with switching auditor. There has been additional internal cost incurred, both in terms of bringing the auditor up to speed - in other words, prior to the audit work being undertaken - but, also, throughout the audit, there was more recourse to internal staff time than had been the case with the previous auditor. I couldn't quantify that, though.	FTSE 250 ACC
Negligible, none.	FTSE 250 ACC

Response	*Respondent position*
I think little, if any, impact, really.	FTSE 250 ACC
Well, for example, one of the difficulties with growing a company is that you grow the company at the rate at which the infrastructure grows as well to be able to manage this growth and [✂] were very good at pointing out to us, 'You need to strengthen your periphery functions' etc and their management letter was nearly a form of consultancy. They didn't do the work subsequently, but they recommended things which we were probably not moving fast enough on. Some of those smaller ones probably wouldn't have got into that and you often find that either a company grows its infrastructure too quickly and then has excessive costs, or it doesn't grow it fast enough and loses control, and you've got to get that balance right. The Big Four - I can only speak for two of the Big Four - when I've been involved with them, are very good at pointing out that you really should be growing this infrastructure more quickly, and have more professionalism there, if you're going to be an extra-competent FTSE-100 company. It depends how demanding the audit is. Fees are about whether there's a lot they have to address, and that's why we agree with them beforehand what the objectives of the audit are and the focus they're going to place on, for example, inventory or quality of debtors or costing a bad debt and so on, and once you've done that, and the management actually are attuned to it, then the costs will come down because the audit is not...For example, my South American company, there is hardly anything that they find in the audit and, therefore, the fees are quite low. They have come down now. They have actually...I mean, the partner's always telling me, 'You know, I'm discounting this at forty percent'. I said, 'What, you want to keep the account, do you?', and he said 'No, it's just that, actually, it is actually easier'. If you put in place quite a good internal audit function, which is part of the management cost, then that helps the audit cost come down overall, assuming everything's reasonably in order. [Asked whether costs were higher in first year?]Oh, they were higher, absolutely, because they had to get in their visits and all that, then they came down, or they're coming down. They are lower, but they're coming down, and on a low trajectory, or a lower trajectory or whatever. Competition is helping make that happen with the Big Four, of course. It's not just us, it's them as well.	FTSE 250 ACC
[Section C not asked as had not switched auditor in the last 5 years - the company in question had only split from its' parent company 2 years ago and had only used one auditor]	FTSE 250 ACC
I don't think you're asking the right question. We didn't incur costs, but it did take up more management time. I'd say it had no impact on internal cost.	FTSE 250 ACC
Well, it was amazing because they always say that if you switch auditors, it's a nightmare for the finance department internally, and everybody's got it...I mean, if I can sort-of describe it and then you can maybe think about what to write. Basically, as part of the tender process, the new firms did a lot of work in how they would do the audit and how they would plan the audit. So, once we chose [✂] they had actually done a lot of the planning work as part of the tender process. So, that made it less of a disruption to try and explain to them what we actually did, because we'd done that in the tender process. The tender process itself was quite time-consuming and quite disruptive for the whole of [COMPANY NAME] but, after the tender process, there was actually very little disruption. Not a material impact. It took up people's time. They just worked a bit harder. Just stress level impact. It didn't actually cost us any money. We didn't pay anybody any overtime for doing the audit tender process. It just involved the whole of the senior management and the whole of the finance team. Probably all twenty people in [COMPANY NAME] working an extra few days to explain to the auditors how it all worked. So, no, it wasn't really a problem, to be honest. Definitely not a material cost, but it was some level of disruption.	FTSE 250 ACC
No significant increase or reduction.	FTSE 250 ACC
[Section C not asked as had not switched auditor in the last 5 years]	FTSE 250 ACC
No, no [when asked if he would know about internal costs, as the respondent had already explained he has only been in the company for one year]	FTSE 250 ACC

Response	*Respondent position*
No significant impact outside of the tender process.	FTSE 250 ACC
Again, I can't answer that one, either. I just wasn't there, so I can't answer.	FTSE 250 ACC
I think, in fairness, none that were significant. I mean, there's obviously, I wasn't involved directly with it, but there was obviously the rebuilding of relationships between internal management and the audit firm, simply because they were new people, but there was no significant impact on our internal costs.	FTSE 250 ACC

Source: IFF.

Competition Commission follow-up survey results

Introduction

1. This appendix sets out the results from the CC's follow-up survey of ACCs of FTSE 350 companies.

2. The follow-up survey was carried out by IFF on behalf of the CC. Further details on the survey are provided by the IFF technical report.[1] IFF supplied the CC with the raw survey output data and tabulations of the results, which formed the basis for this appendix. The IFF tabulations of the results have also been published.[2]

3. The data was collected through a telephone survey designed to last 15 minutes (although some lasted much longer). The ACCs contacted were those FTSE 350 ACCs that had agreed to be contacted for potential follow-up research after the first survey. One hundred and two ACCs were contacted and 71 participated in the follow-up survey, giving a response rate of 70 per cent.

4. The follow-up survey questionnaire contained a number of open-ended questions, the responses to some of which were coded post-interview to a set of categories. Where answers given were long, disparate, or tended to be very specific to the workings of an ACC's company, the responses were not coded. Answers to some questions were not provided to the CC as they might have compromised the anonymity of respondents.[3]

5. The structure of this appendix follows the set-up of the follow-up survey:

   (a) background information regarding the surveyed ACCs;

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[1] www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/cc-commissioned-survey.
[2] www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/cc-commissioned-survey.
[3] For example, the sample company name, or the name of other companies for which the respondent is a member of the board.

(b) the role of ACCs;

(c) how ACCs approached their role;

(d) assessment of external audit quality;

(e) extended reporting to shareholders; and

(f) efficiency measures regarding the audit and AQRT reports.

6. In each section we set out the tabulated responses to the questions or provide an overview of the nature of the verbatim responses received in case they were not coded.

Background information regarding the surveyed ACCs

7. Table 1 shows the share of ACCs surveyed that, in addition to being the ACC for the sample company were also: the ACC on another FTSE 350 AC ('ACC other'); on another FTSE 350 AC but not as ACC ('AC other'); and on a FTSE 350 board but not on the AC ('Board other'). Combining these results, we found that 39 per cent of the ACCs surveyed were on the AC of multiple FTSE 350 companies, mostly in the role of ACC. 6 per cent were also a member of the board at another FTSE 350 company, but not on the AC.

TABLE 1 **Other roles of the ACCs—questions A1/A3/A5**

			per cent
Number	*ACC other*	*AC other*	*Board other*
0	65	90	90
1	18	7	8
2	15	1	1
3	1	1	0
Total	100	100	100

Source: IFF follow-up survey of FTSE 350 ACCs.

8. Table 2 shows the positions that the respondents of the follow-up survey currently held or have held in the past. We found that 89 per cent of respondents were professionally qualified accountants or auditors, and 73 per cent had professional

experience directly relevant to their position as ACC for a FTSE 350 company. 28 per cent of the respondents had previously been audit partners.

TABLE 2 **Positions held currently or in the past—question A7**

Answer	*per cent*
Professionally qualified accountant/auditor	89
Audit Partner	28
Finance Director/Chief Financial Officer of a FTSE 350 company	54
Finance Director/Chief Financial Officer of a non FTSE 350 company	30
Other positions that you consider provided experience of direct relevance to your current position as ACC for a FTSE 350 company	73

Source: IFF follow-up survey of FTSE 350 ACCs.

9. Table 3 shows the number of years the respondents had been ACC for the sample company. We found that 82 per cent of respondents had been active in their current role of ACC for three years or longer.

TABLE 3 **Number of years as ACC for the sample company—question A8**

Answer	*%*	*Cumulative*
Less than one year	3	3
1–2 years	15	18
3–4 years	34	52
5–9 years	48	100
Total	100	

Source: IFF follow-up survey of FTSE 350 ACCs.

10. Table 4 shows how many full-time equivalent working days a month respondents devoted to their role as ACC for the sample company. We found that 77 per cent of respondents spent two days a month or less in their role, though there was substantial variation in this number. Disregarding a single respondent that indicated spending eight days a month in the role, the upper limit of time spent in the role was five days a month.

TABLE 4 **Time devoted to ACC role in days per month—question A9**

Answer	*%*	*Cumulative*
0.25	1	1
0.5	14	15
1	32	48
1.25	1	49
1.5	13	62
2	15	77
2.5	1	79
3	7	86
3.5	1	87
4	7	94
5	4	99
8	1	100

Source: IFF follow-up survey of FTSE 350 ACCs.

The role of ACCs

11. Table 5 shows the range of activities ACCs might undertake in carrying out their responsibilities as ACC. For each activity the respondents were asked to indicate if they engaged in it, and if yes, how often.

TABLE 5 **Frequency with which ACCs engage in audit-related activities—question B1**

per cent

Activity	*Every year*	*Most years*	*Some years*	*Never*	*Don't know*
Taking a view on whether the company has adopted appropriate accounting policies	99	1	-	-	-
Reviewing and agreeing the proposed scope of the external audit work and the approach to this work.	100	-	-	-	-
Understanding the external auditor's methodology for carrying out the audit and approach to the key audit risks	100	-	-	-	-
Agreeing levels of materiality	100				
Assessing whether proposed sample sizes are sufficient	41	1	13	42	3
Understanding the reliance placed by the external auditor on the company's controls	100	-	-	-	-
Satisfying yourself that the company has made appropriate judgements in determining significant estimates	99	-	-	-	1
Reviewing the clarity and completeness of disclosures in the financial statements	99	1	-	-	-
Ensuring that issues identified by external auditors are satisfactorily resolved	100	-	-	-	-
Identifying whether the external auditors have satisfactorily completed the audit plan and understanding the reasons for any changes.	100	-	-	-	-
Satisfying yourself that an appropriate level of review has been applied to the detailed audit work	89	1	1	8	-
Developing the policy for the provision by the external audit firm of non-audit services	87	8	3	-	1

Source: IFF follow-up survey of FTSE 350 ACCs.

12. We found that nearly all ACCs (87 per cent and above) engaged in most of the listed activities on a yearly basis, such as 'Reviewing and agreeing the proposed scope of the external audit work and the approach to this work' and 'Agreeing levels of materiality'.

13. We also found that 42 per cent of the ACCs indicated that they never assessed whether proposed sample sizes were sufficient. A number of respondents indicated that they never satisfied themselves that an appropriate level of review had been applied to the detailed audit work.

14. In addition ACCs were asked which other activities they undertook which were core to fulfilling their responsibilities as ACC for the sample company (question B2). The activities mentioned mostly revolved around dealing with internal audit, financial risk assessments, and reviewing/assessing/interacting with the external auditors and audit partners.

15. Finally we asked which activities ACCs considered to be outside their remit (question B3). Responses mentioned included operational and investment matters, remuneration policy, and overall risk assessments.

How ACCs approached their role

16. We asked the ACCs whether at the sample company there were any constraints they had to manage in carrying out their duties as ACC (question C1). Table 6 shows the percentage of respondents that provided an answer that could be classified into the categories listed in the table. We found that the biggest constraint to ACCs was the time available (6 per cent). Most of the respondents (76 per cent) did not indicate any constraints.

TABLE 6 **Constraints faced by the ACC—question C1**

Answer	*%*
Time available	6
Some operations are overseas (makes oversight more difficult)	4
The size/diversity of activities of the company (makes oversight more challenging)	4
Logistics of arranging meetings for the ACC/execs	3
How much detail should the AC go into/being able to go into the audit process in enough detail	3
Other	6
No—Nothing	76

Source: IFF follow-up survey of FTSE 350 ACCs.

17. We asked the ACCs three discrete questions on how they approached their role (questions C2/C5/C8). The first enquired if there had been any circumstances, in the last three to five years, where their particular views and opinions as an ACC had caused disagreement with executive directors. The second asked whether the AC in the last three to five years had requested any supplementary information on external audit matters beyond those which they expected to be provided with as part of the normal AC agenda. The third investigated whether in their role as ACC for the sample company they had ever engaged resources, or asked the company to engage resources, independent of the company and external auditors to obtain advice on an external audit or financial reporting issue. Table 7 shows the complete distribution of the answers to these three questions.

TABLE 7 **How ACCs approach their role—questions C2/C5/C8**

per cent

Answer	*Disagreement with executives*	*Requested information*	*Engaged additional resources*
Yes	31	52	24
No	68	45	76
Don't know/refused	1	3	—
Total	100	100	100

Source: IFF follow-up survey of FTSE 350 ACCs.

18. We found that 31 per cent of ACCs said that, in the last three to five years, there had been circumstances where their views and opinions as an ACC had caused disagreement with executive directors. In a follow-up question (C3) ACCs were asked

what the circumstances for the disagreement were and how often such disagreements had occurred. Many said that such disagreement was rare or infrequent. The nature of the disagreement included provisioning policies, accounting policies and practices, and levels of disclosure. Generally these were said to be have been satisfactorily resolved. A number of the respondents said that such disagreement, when it occurred, should be regarded as reflective of a healthy debate and challenge within executive management.

19. Another follow-up question (C4) investigated what the ACCs felt was the reason no disagreements had arisen with the executive directors. Table 8 shows for each response category the percentage of respondents that provided an answer that could be classified into that category. Most respondents indicated that no disagreements had arisen as they had an open dialogue/healthy debate with executives. Some also said that no significant audit-related issues had arisen, and others pointed to the professionalism of the executives.

TABLE 8 **Why disagreements have not arisen—question C4**

Answer	*%*
There have been no significant issues/the need has not arisen	15
There is an open dialogue/(healthy) debate, through which agreement is reached	81
Positive mention of the executive/finance team's capability	15
Other	13
Don't know	0
Refused	0

Source: IFF follow-up survey of FTSE 350 ACCs.

20. As shown in Table 7, 52 per cent of ACCs indicated that in the past three to five years the AC had requested supplementary information, beyond that which they expected to receive as part of a normal AC agenda. A follow-up question (C6) asked ACCs what the nature and extent of the supplementary information requested was and how frequently such information was requested. The supplementary information covered areas such as accounting standards, a deeper review of specific topics or

areas, or benchmarking the company's internal procedures to those of its peers. Respondents indicated that it was typically requested on a yearly basis.

21. Another follow-up question (C7) to those ACCs that did not request supplementary information, investigated the reason the AC had not found it necessary to request supplementary information. Table 9 shows the percentage of respondents that provided an answer that could be classified into the categories listed in the table. The large majority of ACCs indicated that they had not requested supplementary information as the information provided had been adequate. Others indicated that the need for supplementary information could be avoided through proper planning, and that additional information could also be retrieved internally.

TABLE 9 **Why not requested supplementary information—question C7**

Answer	*%*
Have not needed to as information provided has been adequate	72
information needs are dealt with/discussed in advance (pre-empting the need to ask)	28
Provided through the internal auditor	6
Other	13

Source: IFF follow-up survey of FTSE 350 ACCs.

22. As shown in Table 7, about one-quarter (24 per cent) of the ACCs surveyed indicated that they had engaged resources independent of the company and its external auditors to obtain advice on an external audit or financial reporting issues. A number of follow-up questions (C9, C11, and 12) investigated how often ACCs engaged such resources, what the circumstances were when they last did this, and from whom they needed to obtain approval to engage such resources. In general these respondents indicated that they had done so around once a year or less and that they were mainly looking for a second opinion, either to obtain additional assurance, or because there were doubts about the information that had been provided. Another common reason for engaging additional resources was the necessity of additional expertise in areas other than statutory audit, such as valuation or legal matters. In all cases there

seemed to be no, or a very straightforward, approval process for engaging such additional external resources.

23. Another follow-up question (C10) investigated the reason the AC had not found it necessary to engage resources independent of the company and the external auditor. Table 10 shows the percentage of respondents that provided an answer that could be classified into the categories listed in the table. The large majority of ACCs indicated that there had been no need to do this. Others indicated that any issues were resolved with internal expertise.

TABLE 10 **Why not engaged resources independently—question C10**

Answer	*%*
There has been no need	80
We are able to resolve issues/find answers with internal expertise (and/or with the auditor)	24
Other	4

Source: IFF follow-up survey of FTSE 350 ACCs.

Assessment of external audit quality

24. Table 11 lists aspects related to the audit that might be relevant for an ACC to assess. For each aspect the respondents were asked whether they were very confident, quite confident, not very confident, or not confident at all, that they were able to assess them.

TABLE 11 **Assessment of the external audit quality—question D1**

per cent

Area	*Not confident at all*	*Not very confident*	*Quite confident*	*Very confident*	*Don't know*	*Not applicable*
The appropriateness and sufficiency of the expertise and experience of the audit team	-	-	18	82	-	-
Whether the external auditor resources allocated in the audit plan are sufficient for the auditors to do a good job	-	-	34	65	1	-
The robustness and perceptiveness of auditors in handling key judgements on accounting policies	-	-	15	85	-	-
Whether sample sizes are appropriate	4	14	38	23	8	13
Whether substantive audit work has been carried out to a satisfactory standard	1	4	32	59	1	1
Whether the auditor has a sufficient understanding of the business to identify issues of concern	-	-	10	90	-	-
Whether substantive audit work has had an appropriate level of review	-	1	44	51	1	3
25. Whether the auditor has an accurate appreciation of internal controls within the company	-	-	23	77	-	-

Source: IFF follow-up survey of FTSE 350 ACCs.

26. Generally almost 100 per cent of the respondents were either 'very confident' or 'quite confident' in their ability to make an assessment regarding the aspects listed. The one aspect on which fewer ACCs felt confident was their ability to assess whether sample sizes were appropriate: only 61 per cent said they were very or quite confident about this. Quite a number of respondents also indicated that the area was 'not applicable' (13 per cent) or that they 'don't know' (8 per cent), which suggests that some did not consider it their responsibility to assess this area. This is in line with the result presented in Table 5 that a large share of ACCs (42 per cent) never assessed whether proposed sample sizes were sufficient.

27. Table 12 shows the share of respondents that indicated they needed to push for an increase in sample sizes or a decrease in materiality thresholds to increase assurance. We found that 10 per cent of ACCs had in the past pushed for an increase in sample sizes, and 14 per cent had pushed for a decrease in materiality thresholds. A

follow-up question (D3) asked ACCs who pushed for such changes what the circumstances were that led them to do that. Mostly it was not related to the quality of the statutory audit, but had more to do with additional assurance, new operations, and issues at specific subsidiaries.

TABLE 12 **Increase in sample sizes/decrease in materiality thresholds—question D2**

Answer	*%*
Yes—an increase in sample sizes	10
Yes—an decrease in materiality thresholds	14
No—neither	83
Don't know/refused	0

Source: IFF follow-up survey of FTSE 350 ACCs.

28. Another follow-up question (D4) investigated the reason the ACCs felt it had not been necessary to push for increased sample sizes or a decrease in materiality thresholds. Table 13 shows the percentage of respondents that provided an answer that could be classified into the categories listed in the table. Almost half the respondents indicated that they were confident the sample sizes and materiality thresholds were correct. Other respondents indicated that such details would be discussed prior to the audit. 12 per cent of respondents indicated that determining sample sizes was not the role of the AC.

TABLE 13 **Why has this not been necessary—question D4**

Answer	*%*
Confidence that these things are correct	47
This would be discussed prior to/during the audit	27
Confidence that materiality levels are correct	17
Determining sample sizes is not the role of the Audit Committee	12
Other	14

Source: IFF follow-up survey of FTSE 350 ACCs.

29. Table 14 shows the number of respondents that indicated there were particular aspects of the quality of the external audit that were not normally visible to the AC. We found that 28 per cent of respondents said that there were aspects of audit quality that were not normally visible to them. A follow-up question (D6) asked these

respondents which aspects of external audit quality were not normally visible to the AC. Examples given were audit details such as sample sizes, internal reviews and tests carried out by audit firms, and staffing questions such as the quality of more junior staff or the overseas audit teams.

TABLE 14 **Aspects of external audit quality no visible to AC—question D5**

Answer	*%*
Yes	28
No	66
Don't know/refused	6
Total	100

Source: IFF follow-up survey of FTSE 350 ACCs.

30. The follow-up survey asked all respondents about the extent to which they were able to assess, in a tender process, the quality of the audit that would be delivered by the firms tendering (question D7). Even though some ACCs indicated that this was difficult, we found that most ACCs were confident they could assess the quality a firm would deliver. The most important aspect considered to evaluate this prospective quality were the audit firms' people, most notably the engagement partner. Other aspects typically investigated were the firms' experience, expertise, reputation, and geographic coverage.

31. In addition, the follow-up survey asked all the respondents the extent to which they were able to assess the quality of the audit that could be delivered by audit firms other than their current auditor, outside a tender process (Question D8). Some ACCs indicated that this was difficult or only possible to a limited extent, but more than 75 per cent of respondents felt they could assess such quality outside of a tender one way or another. Many of the ACCs surveyed indicated that they had worked with various audit firms, and felt they had an understanding of the service quality offered. Alternative sources of information regarding quality included feedback from contacts in their professional network, the general reputation the audit firms had in the market,

and regulatory reports. ACCs mentioned that the audit firms' employees were useful indicators of the quality of the audit firm (how they presented themselves, whether they understood the sector), as was the firms' global coverage.

Extended reporting to shareholders

32. The follow-up survey posed two discrete questions to the ACCs on how they approached their role (E1/E3). The first enquired if there were any barriers to the ACC or the AC taking the decision to provide shareholders with more information (eg through the AC report) than was currently provided by the published accounts. The second asked whether the respondent was ever approached by shareholders of the company to discuss the company's financial reporting or audit, or requested more information in this regard. Table 15 shows the complete distribution of answers to these two questions.

TABLE 15 **Extended reporting—questions E1/E3**

per cent

Answer	*Barriers for more information*	*Approached for more information*
Yes	17	10
No	83	90
Don't know/refused	0	0
Total	100	100

Source: IFF follow-up survey of FTSE 350 ACCs.

33. We found that 17 per cent of ACCs said that there were barriers to the provision of further information. A follow-up question (E2) asked ACCs to indicate what these barriers were. Many respondents indicated that the commercial sensitivity of the information was a barrier to further disclosure, and suggested that this was the primary barrier.

34. 10 per cent of ACCs we spoke to in the follow-up survey said they had been approached by shareholders for further information. A follow-up question (E4) asked

those who had not been approached for their views on why this was the case. Many respondents were of the view that there was not widespread demand for further information among shareholders. In particular, the reasons given included: there was no demand for further information; that company accounts were already too long; shareholders were satisfied with the information provided.

35. The follow-up survey asked all respondents what they thought shareholders may want by way of additional information in relation to an audit (question E5). Of those that provided an answer (44 per cent responded), the types of information identified included: the scope of the audit, levels of materiality, key financial risks, areas of accounting judgements, details of the work undertaken by the auditors, issues discussed by the AC, and performance of the business at a more granular level.

Efficiency measures regarding the audit and AQRT reports

36. The follow-up survey posed three discrete questions to the ACCs related to audit firms seeking efficiencies and a reduction of overall audit hours (F1/F2/F5). The first enquired whether in their capacity as ACC for the sample company they were aware of any instances where the external auditor had proposed significant reductions in audit hours. The second asked whether the AC at the sample company would be able to assess whether efficiency savings proposed by auditors were compromising audit quality. The third investigated whether in their capacity as ACC for the sample company they had any experience in the last three to five years of evaluating proposed measures for improving the efficiency of the audit. Table 16 shows the complete distribution of answers to these three questions.

TABLE 16 **Efficiency savings proposed by auditors—questions F1/F2/F5**

per cent

Answer	*Reduction of audit hours proposed*	*Able to assess effect on audit quality*	**Experience evaluating efficiency measures*
Yes	14	93	71
No	83	4	29
Don't know/refused	3	3	0
Total	100	100	100

Source: IFF follow-up survey of FTSE 350 ACCs.

*Sample for F5 is reduced from 71 to 66 respondents as they chose not to continue the survey.

37. We found that for 14 per cent of respondents the external auditors had proposed a reduction in audit hours. In addition to that, 93 per cent indicated that the AC would be able to assess whether proposed efficiency savings by auditors compromised audit quality. An open follow-up question (F3) investigated how the AC would be able to make this assessment, and most respondents said they would do this based on the explanations provided by the external auditor together with additional discussion/ questioning/challenging where necessary. Others said they assessed the quality of reporting to the AC, relied on their own experience/expertise, and compared the audit planning/hours/scope with that of the previous year. Respondents who indicated that the AC would not be able to make this assessment, in the follow-up question (F4), mostly said they fully relied on the external auditor for this.

38. We found that 71 per cent of respondents indicated that they had experience in evaluating proposed efficiency measures. A follow-up question (F6) investigated how the ACCs had satisfied themselves that the proposed measures for improving the efficiency of the audit would not result in a reduced audit quality. Table 17 shows the percentage of respondents that provided an answer that could be classified into the categories listed in the table. Most answers related to some sort of discussion or evaluation of the proposed measures, both internally and externally.

TABLE 17 **How assured measures do no lead to reduced audit quality—question F6**

Answer	*%*
Through discussion/evaluation (unspecified with whom in the company)	49
Through discussion with the external auditor	26
Through discussion/evaluation with the company's finance team/management	13
Use of an internal auditor	13
Through own experience/professional judgement	11
Confidence in the external auditor (in their credentials, integrity)	11
Through discussion/evaluation with the Audit Committee	4
Other	17

Source: IFF follow-up survey of FTSE 350 ACCs.

39. The follow-up survey asked two discrete questions to the ACCs related to AQRT reports (F7/F8). The first asked whether the ACC's company's external auditor had been the subject of an AQRT report. The second asked to those whose external auditor had been the subject of an AQRT report, whether they saw a copy of the report. Table 18 shows the complete distribution of answers to these questions.

TABLE 18 **AQRT reports for the external auditor—questions F7/F8**

per cent

Answer	*External auditor subject to AQRT report**	*Seen a copy of the report†*
Yes	64	98
No	30	2
Don't know/refused	6	0
Total	100	100

Source: IFF follow-up survey of FTSE 350 ACCs.

*Sample for F7 is reduced from 71 to 66 respondents as they chose not to continue the survey.
†Sample for F8 is 42 respondents (64 per cent of the remaining 66 respondents).

40. We found that for 64 per cent of the respondents the sample company's external auditor had been the subject of an AQRT report.[4] Of those, 98 per cent saw a copy of the report. In many cases respondents indicated that the report was positive or that only minor issues were raised.[5]

[4] The question did not clearly specify whether this should be an AQRT report on an audit of the sample company, or a general AQRT report on the audit firm. Therefore it might have been interpreted in both ways.
[5] See responses to the CC follow-up survey of FTSE 350 ACCs, question F9.

41. A follow-up question (F10) investigated how, if at all, the ACCs reacted or made changes as a result of the AQRT report. Table 19 shows the percentage of respondents that provided an answer that could be classified into the categories listed in the table. We found that 32 per cent of respondents discussed the report with the external auditor, and 15 per cent made or planned to make changes as a result of the report. In most cases no changes were necessary.

TABLE 19 **How did you react as a result of the AQRT report—question F10**

Answer	*%*
Discussed the changes to be made with the external auditor	32
Discussed it with the Audit Committee	7
Yes—made/plan to make changes	15
No—did not make changes	12
Other	2
No changes necessary	54
Don't know	2

Source: IFF follow-up survey of FTSE 350 ACCs.

Descriptive statistics

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Introduction

1. This appendix provides results from the analysis of the public and engagement data sets.

2. The public data set contained company level audit related and financial information for companies that were members of the FTSE 350 at any time in the period 2001 to 2011 or members of the Top Track 100 at any time in the period 2006 to 2011. This amounted to 712 FTSE 350 companies and a further 133 Top Track 100 companies. The data was collected and checked by the main parties. We do not present statistics for 2011 as the sample of companies for this calendar year is incomplete (see paragraph 10).

3. The engagement data set contained audit firm engagement level information on the UK audit fee and the hours spent on the engagement for the period 2006 to 2011. The data was provided by audit firms in response to a data request issued to all UK audit firms that had audited a FTSE 350 or Top Track 100 company in the period 2006 to 2011. This amounted to 542 FTSE 350 companies and a further 133 Top Track 100 companies.[1] Statistics based on the engagement data set are reported for each calendar year.

4. The first section of the appendix presents statistics derived from the public data set. For the period 2001 to 2010, we calculate:

   (a) audit firms' annual shares of audit fees by index designation, turnover and industry (further results are provided in Annex 1 including shares of audit engagements);

   (b) annual median audit fees, median audit fees per £1 million turnover and real annual changes in audit fee by index designation;

   (c) the ratio of non-audit fees to audit fees;

   (d) how often companies have switched auditor by index designation, and the association between switching and M&A activity and moves to or from joint audits; and

   (e) the rates of switching between audit firm pairs.

5. Using the public data set we also *(f)* provide an analysis of audit fees before and after switching audit firm and *(g)* calculate the distribution in the tenure of the current auditor.

6. The second section gives statistics derived using the engagement level data set. For the period 2006 to 2011 we calculate:

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[1] More detail of the public and engagement data sets is given in Appendix 6.

(a) the proportion of staff hours allocated to audit engagements accounted for by different grades by firm and index designation;

(b) audit fee per hour by firm and index designation, and real changes in audit fees per hour by index designation; and

(c) an analysis of fee rates per hour and composition of engagement teams before and after switching.

7. Using the engagement data set we also provide *(d)* partner scale rates by firm and index designation and *(e)* an analysis of revenue recovery rates by firm for FTSE 350 companies.

8. The third section provides an analysis of the movements of companies between different index designations and the association of these movements with switching audit firm and M&A activity. This analysis is based on the public data set.

9. The fourth section provides an analysis of the characteristics of companies that have not switched audit firm in the last ten years. This analysis is based on the public and engagement data sets.

Section 1—Results derived from the public data set

10. For statistics reported annually, 'year' represents the calendar year. Company reports were matched to the calendar year in which the largest portion of the report fell. For example, two reports with year-ends 31/12/2007 and 31/08/2007 would both be assigned to calendar year 2007. After assigning reports to calendar years the sample of companies for 2011 was incomplete, therefore statistics are not reported for 2011.

11. There were a small number (approximately 2 per cent) of reports that were not 12 months long. The data in these reports was annualized.

12. All financial variables were deflated to March 2005 prices using the CPI. The data was deflated using the index value of the month in which a company's (or audit firm's) financial year ended.

13. We report statistics by the index designation of a company in a given calendar year (eg FTSE 100, FTSE 250 or non-FTSE 350). We used the company's index designation in September as the status for the year. We could distinguish whether a company was listed but not in the FTSE 350 index or privately owned; however, we did not have a complete set of companies for these designations. These companies are grouped together and defined as non-FTSE 350 in the statistics presented.

14. Companies were given an industry classification using the four digit ICB codes introduced in 2006. Companies that ceased to exist before 2006 were assigned a four digit code based on the name of the industry, sector or super-sector in the old and new classifications.

Market shares

15. Market shares were calculated for each year 2001 to 2010 based on audit engagements and total audit fees by indexation and company turnover. We distinguished between the Big 4 audit firms, BDO, GT and 'other' audit firms (Arthur Andersen was treated separately in the years it was in operation).

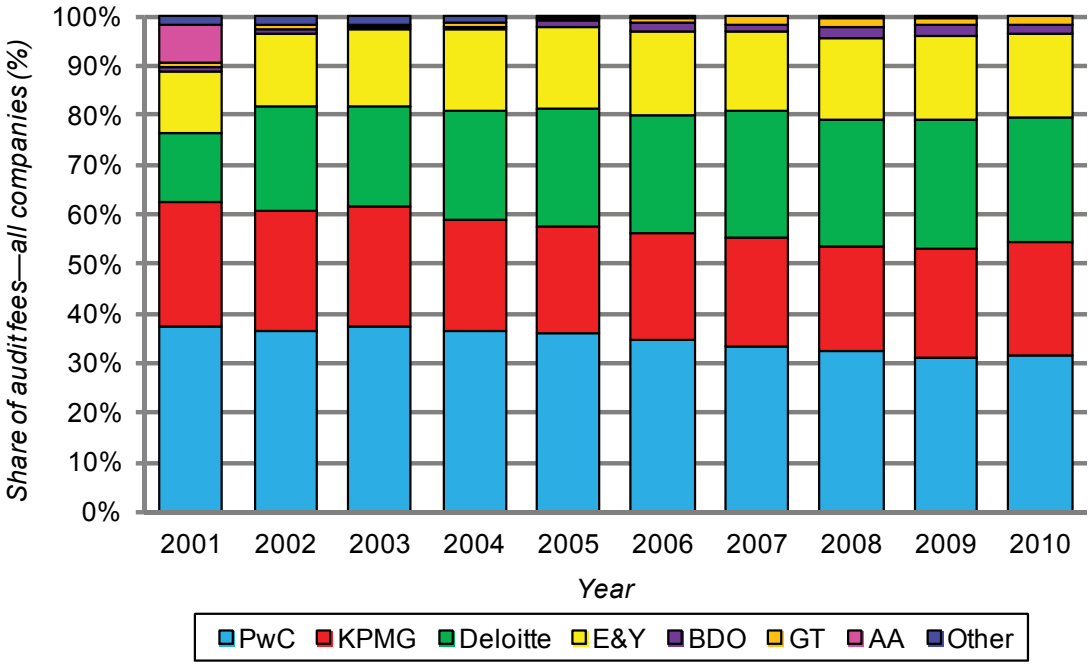
16. Joint audits were assigned to one audit firm only.[2] Excluding joint audits from the market share calculations did not have a material effect at the total status level (eg FTSE 100, FTSE 250 etc). However, we identified some FTSE 350 industry level shares which might change depending on the treatment of joint/shared audits.[3]

17. In the main text we report results for annual shares of audit fees for all engagements in the data set, FTSE 350 engagements and non-FTSE 350 engagements. In Annex 1 we report a full set of results for shares of audit fees and engagements by year, indexation, company turnover and sector.

18. Figures 1 and 2 show the annual shares of audit fees earned from all companies and from all FTSE 350 companies.

FIGURE 1

Annual shares of audit fees, all companies, 2001 to 2010



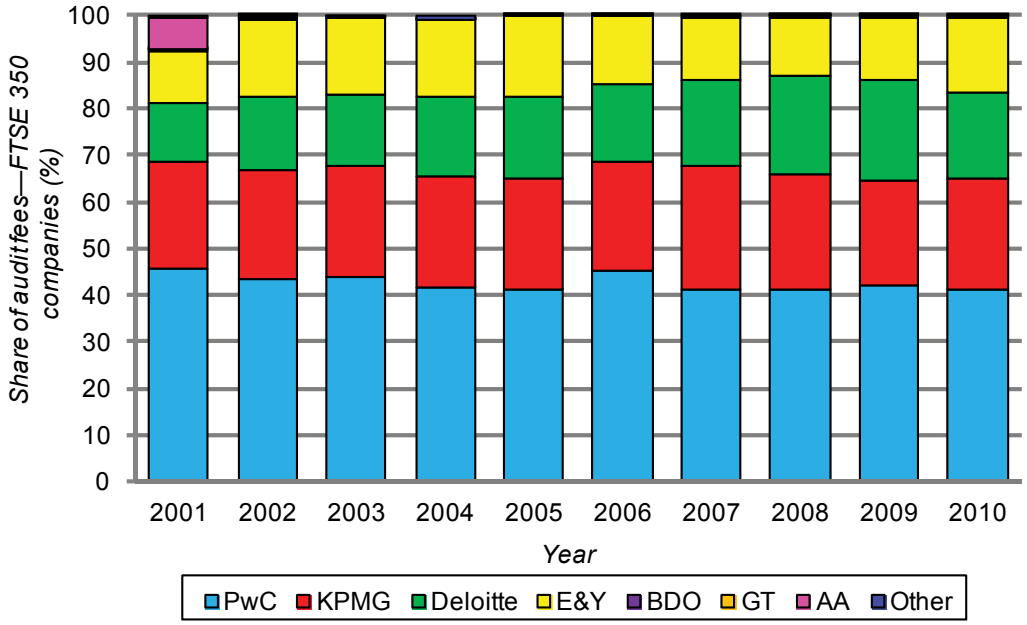
Source: CC analysis.

[2] We were not able to accurately apportion audit fees to individual firms conducting joint audits. The engagement was assigned to the firm which conducted the engagement on an individual basis in the years before and/or after the years in which a joint audit was conducted (there was one exception where the company had a joint audit in each year. The audit was conducted jointly by a firm in the UK and a firm overseas. The engagement was assigned to the firm based in the UK).

[3] The industries that could be affected are: Basic Materials 2001, 2002; Financials 2001-2007; Oil & Gas 2001–2004; Technology 2001–2002. The extent of any effect would depend on the number of companies in each industry in each year.

FIGURE 2

Annual shares of audit fees, FTSE 350 companies, 2001 to 2010



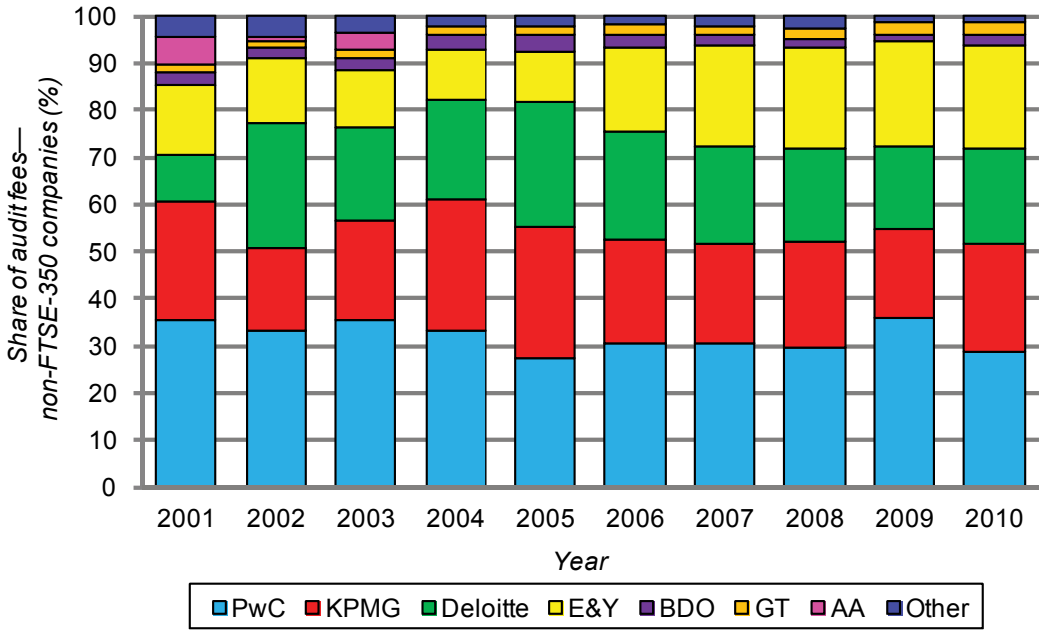
Source: CC analysis.

19. Figures 1 and 2 show that the Big 4 firms consistently earned over 96 per cent of total audit fees generated by all engagements and over 99 per cent of total audit fees earned from FTSE 350 engagements. PwC had the highest share of the Big 4 firms.

20. Figure 3 shows the annual shares of audit fees among non-FTSE-350 companies.

FIGURE 3

Annual shares of audit fees, non-FTSE-350 companies, 2001 to 2010



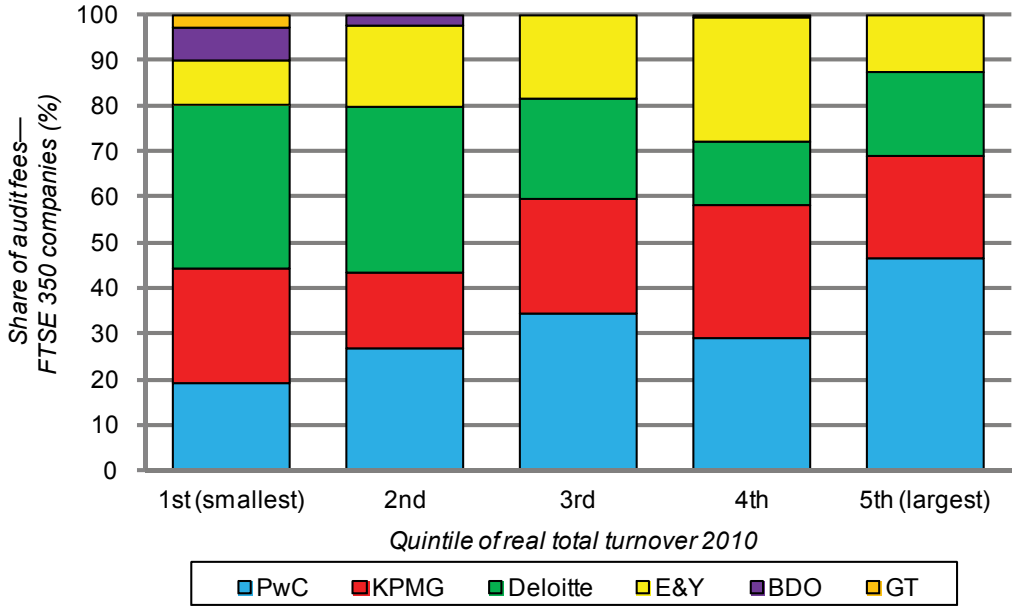
Source: CC analysis.

21. Figure 3 shows that the supply of statutory audit services was less concentrated among the non-FTSE-350 companies in the sample: the Big 4 accounted for between 92 and 95 per cent of total audit fees earned from non-FTSE 350 engagements.

22. To calculate shares by company turnover we allocated FTSE 350 engagements to five groups on the basis of total company turnover. The results for FTSE 350 engagements by audit fees in 2010 are shown in Figure 4 below.

FIGURE 4

Annual shares of audit fees by total turnover, FTSE 350 companies, 2010



Source: CC analysis.

23. We observed that apart from the largest 20 per cent of companies each of the Big 4 firms had a considerable share of audit fees. EY had a relatively small share of the largest engagements compared with the other Big 4 firms. BDO and GT had their largest shares of fees among the smallest 20 per cent of companies.

24. Tables 1 and 2 report shares of FTSE 350 audit engagements and FTSE 350 audit fees in 2010 by sector.

TABLE 1 **Industry shares of FTSE 350 audit engagements 2010**

per cent

Industry	*Total No*	*PWC*	*DEL*	*KPMG*	*EY*	*BDO*	*GT*	*Big 4*
Financial services	75	32.0	25.3	16.0	21.3	1.3	4.0	94.7
Consumer services	64	29.7	26.6	18.8	20.3	1.6	3.1	95.3
Industrials	61	27.9	31.1	34.4	4.9	1.6	0.0	98.4
Consumer goods	26	53.8	11.5	26.9	7.7	0.0	0.0	100.0
Oil & Gas	21	33.3	28.6	9.5	28.6	0.0	0.0	100.0
Technology	17	35.3	17.6	17.6	29.4	0.0	0.0	100.0
Insurance	17	35.3	11.8	23.5	29.4	0.0	0.0	100.0
Mining	16	18.8	31.3	12.5	31.3	6.3	0.0	93.8
Basic materials	9	22.2	33.3	33.3	11.1	0.0	0.0	100.0
Utilities	9	33.3	33.3	22.2	11.1	0.0	0.0	100.0
Health care	8	12.5	37.5	37.5	12.5	0.0	0.0	100.0
Real estate	8	25.0	0.0	37.5	12.5	12.5	12.5	75.0
Telecommunications	7	28.6	42.9	28.6	0.0	0.0	0.0	100.0
Banks	5	40.0	20.0	40.0	0.0	0.0	0.0	100.0
Total	343	31.5	25.4	22.7	17.2	1.5	1.7	96.8

Source: CC.

TABLE 2 **Industry shares of FTSE 350 audit fees 2010**

per cent

Industry	*Total £m*	*PWC*	*DEL*	*KPMG*	*EY*	*BDO*	*GT*	*Big 4*
Financial services	42.4	40.9	18.0	8.6	32	0.3	0.2	99.4
Consumer services	92.0	28.8	47.3	10	12.4	0.5	1.2	98.3
Industrials	100.6	30.0	20.2	45.1	4.4	0.3	0.0	99.7
Consumer goods	72.3	76.5	1.9	20.8	0.8	0.0	0.0	100.0
Oil & Gas	83.7	52.6	3.9	0.5	43	0.0	0.0	100.0
Technology	19.8	43.7	23.7	3.1	29.5	0.0	0.0	100.0
Insurance	94.5	14.4	6.6	31.5	47.5	0.0	0.0	100.0
Mining	54.2	27.1	19.6	27.7	24.8	0.8	0.0	99.2
Basic materials	8.4	10.6	55.9	25.1	8.4	0.0	0.0	100.0
Utilities	23.2	72.1	8.0	18.6	1.3	0.0	0.0	100.0
Health care	30.5	54.1	9.7	29.8	6.4	0.0	0.0	100.0
Real estate	2.0	34.9	0.0	36.0	2.2	15.2	11.8	73.0
Telecommunications	25.0	41.7	42	16.3	0.0	0.0	0.0	100.0
Banks	168.7	47.3	19.7	33.0	0.0	0.0	0.0	100.0
Total	817.3	41.0	18.5	23.9	16.3	0.2	0.2	99.6

Source: CC.

25. The number of audit engagements and the presence of different audit firms varied across industry classification. For example, there were a relatively small number of engagements in the banking, basic materials and telecommunications sectors, and only three firms (PwC, Deloitte and KPMG) supplied audit services to these companies. EY had only a 5 per cent share of industrial company audits. In the consumer goods and oil & gas industries two firms accounted for more than 95 per cent of audit fees.

Audit fees

26. We report the annual median audit fee (in March 2005 prices) and the annual median audit fee (in March 2005 prices) per £1 million total turnover in each index designation. We normalized by total turnover to control to an extent for the size and complexity of different audits and material changes in company size.

27. [✂] and PwC highlighted limitations associated with using total company turnover to control for the size and complexity of different audits. While PwC welcomed the CC's attempt to control for scope, it raised several concerns:

    (a) For some companies there was little correlation between audit scope and turnover. For these companies, there was often a high degree of correlation between audit scope and the company's assets.

    (b) Where there was a correlation between audit fee and turnover, the increase in audit fees tended to be proportionately much less than the extent of higher turnover.

    (c) The ratio of the maximum to minimum values for this variable (audit fee divided by turnover) was very much greater than when the absolute level of audit fee was used.

    (d) Presenting audit fees alone would overstate the increase in audit fees by not controlling for scope, while presenting audit fees divided by company turnover would understate the increase in audit fees by over-controlling for scope.

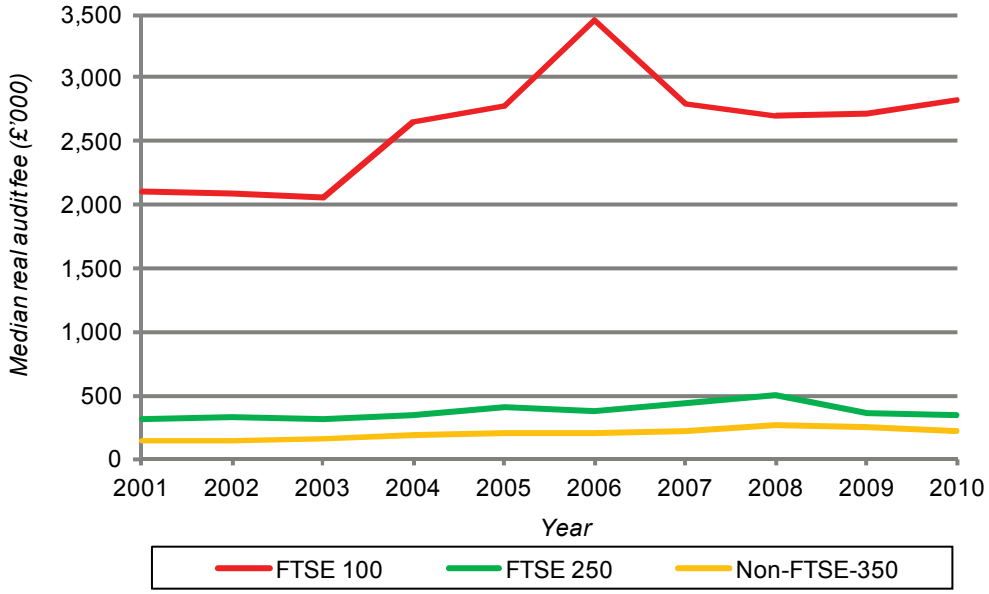
28. We recognize that turnover is not a perfect measure by which to control for the scale and complexity of an audit, but given the available data there are no suitable alternatives. Data on current and non-current assets was collected as part of the public data set, but we do not report separate analysis using assets to control for the size and complexity of an audit. Although not reported, we note that in the context of Figure 6

below, the median fee per £1 million total assets followed a broadly similar trend to median fee per £1 million turnover for each index designation.

29. Figures 5 and 6 show the median audit fee (in March 2005 prices) and median audit fee per £1 million total turnover for FTSE 100, FTSE 250 and non-FTSE-350 companies for each year 2001 to 2010.

FIGURE 5

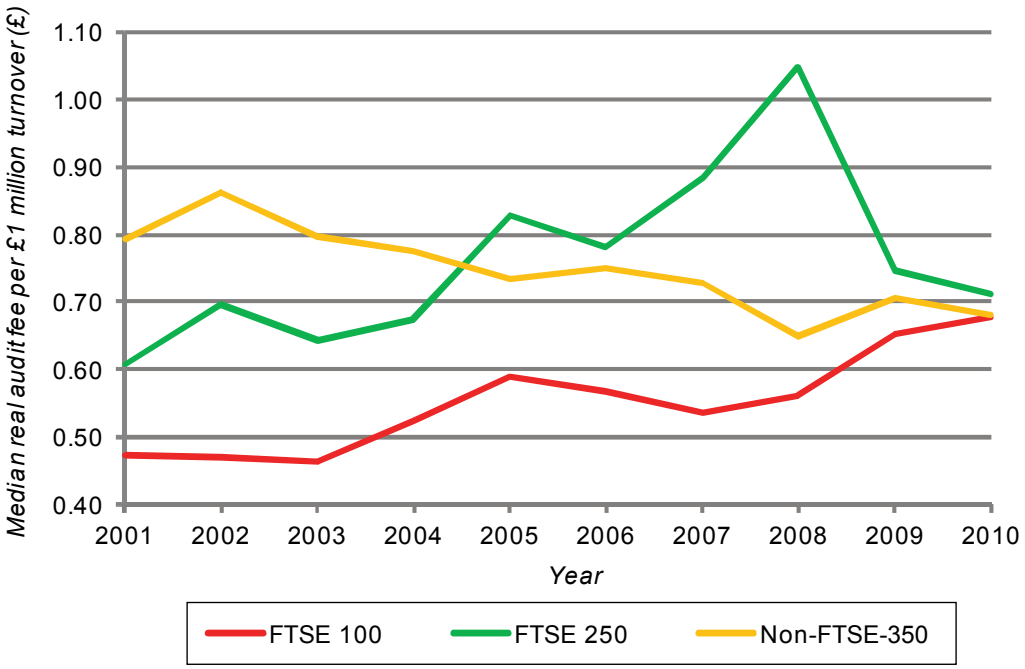
Median audit fee (March 2005 prices) by index designations 2001 to 2010



Source: CC analysis.

FIGURE 6

Median audit fees (March 2005 prices) per £1 million turnover by index designations 2001 to 2010



Source: CC analysis.

30. Figure 5 shows that the median audit fee for FTSE 100 companies was substantially higher than for FTSE 250 and non-FTSE-350 companies. However, relative to the size of the company audit fees for FTSE 100 companies were smaller than FTSE 250 and non-FTSE-350 companies.

31. Among FTSE 350 companies we observed considerable variation in audit fees and considerable variation in the real change in audit fees from year to year. This is shown in Table 3 below. We report the median, minimum and maximum audit fee (in March 2005 prices) for each year and the median, 10th and 90th percentiles for the real change in audit fee compared with the previous year.[4]

[4] We exclude the largest and smallest 10 per cent of fee changes to exclude outlier, for example as a result of substantial mergers.

TABLE 3 **Summary statistics of audit fees (in March 2005 prices) and real changes in audit fees, FTSE 350 companies, 2001 to 2010**

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
										£'000
Audit fee										
Median	529	623	513	604	693	672	659	769	548	579
Min	9	9	8	10	10	13	6	16	16	14
Max	24,120	33,903	28,775	33,108	41,931	40,385	36,723	39,269	41,215	44,521
										per cent
Real audit fee change										
Median		6	5	7	14	2	1	5	–2	–4
10th percentile		–11	–26	–12	–9	–27	–23	–17	–22	–24
90th percentile		55	50	51	78	58	41	40	35	15

Source: CC.

32. For example, in 2010 the median audit fee (in March 2005 prices) was £579,000 with a range from £14,000 to £44.5 million. In 2010 we also observed a 4 per cent real decrease in the median audit fee compared with 2009 fees. In 2010, 80 per cent of FTSE 350 companies experienced real changes in audit fees, compared with 2009, in the range of a 24 per cent decrease to a 15 per cent increase.

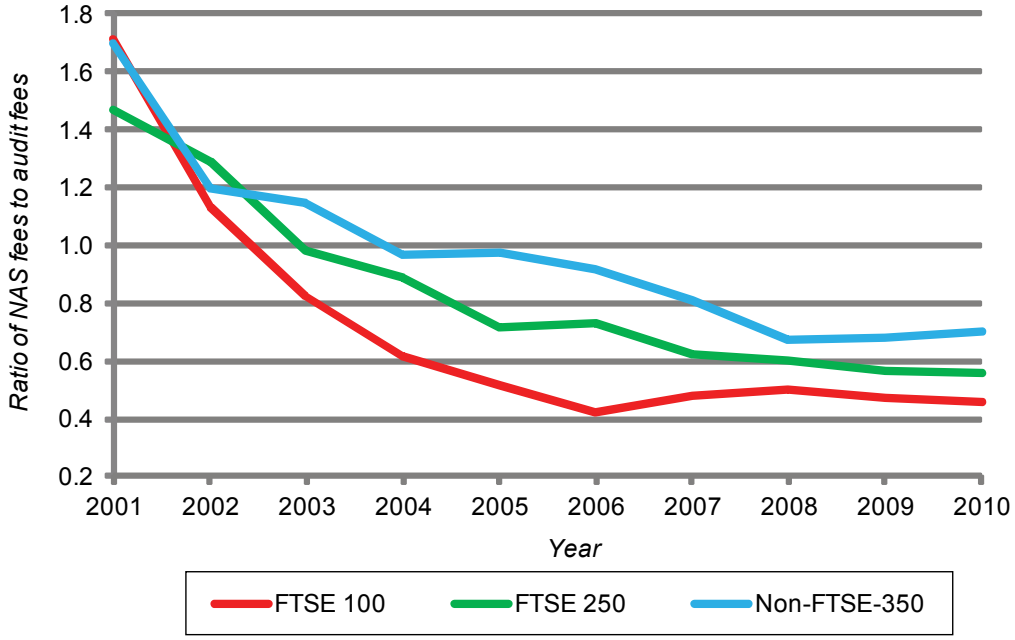
Ratio of non-audit-service fees to audit fees

33. We calculated the annual ratio of non-audit-services fees to total audit fees across all FTSE 100, FTSE 250 and non-FTSE-350 companies. A ratio of 0.5 means that total NAS fees earned by all audit firms was equal to 50 per cent of the total audit fees paid to all audit firms in a given year.

34. Figure 7 shows the annual ratio of NAS to audit fees earned by all audit firms in each index designation. The ratio has decreased over time. Generally FTSE 100 companies had the lowest ratio.

FIGURE 7

Annual ratio of NAS to audit fees by index designation, 2001 to 2010



Source: CC analysis.

Switching rates

35. We identified a total of 313 instances (245 excluding switches from Arthur Anderson and where a company moved to/from a joint audit) when a company switched auditor in the period 2001 to 2010. Excluding switches from Arthur Andersen and instances related to joint audit we identified 19 FTSE 100 switches, 64 FTSE 250 switches and 162 non-FTSE-350 switches.

36. We calculated the proportion of companies that switched auditor each year and over a five-year rolling period by index designation. These calculations excluded any companies that switched from Arthur Andersen. Main parties argued that switches from Arthur Andersen should be included in the calculation of switching rates. PwC argued that switches from Arthur Andersen (as well as other switches) involved an explicit decision which resulted in a change of auditor and competitive pressures were

brought to bear on the audit firm (albeit for different reasons according to specific circumstance).[5] Deloitte stated that not one client was an automatic transfer to Deloitte and that clients had to make an informed decision as to who they would appoint as auditors. KPMG said that even though switches from Arthur Andersen were due to external factors, companies made explicit decisions regarding the choice of auditor post Arthur Andersen.

37. We do not agree with the parties that switches from Arthur Andersen should be included in our 'headline' estimates of switching rates due to the exceptional circumstances. In particular, although some companies might have switched auditor anyway, we think it reasonable to assume that for many switching auditor was not of their choosing.

38. KPMG also argued that situations where two companies with different auditors merged and retained only one of the incumbent auditors should be considered as a switch as the merged company has to make a genuine choice between the two incumbent auditors. Such events are included in the results presented in Figure 8 and Table 4 where the merged entity has retained the corporate identity of one of the merging companies, and that company has switched auditor.

Switching rates by index designation

39. When calculating switching rates for a particular index designation (eg FTSE 350, non-FTSE-350 etc) we considered switches by companies that were part of the index designation in the year of interest (as defined in paragraph 13).

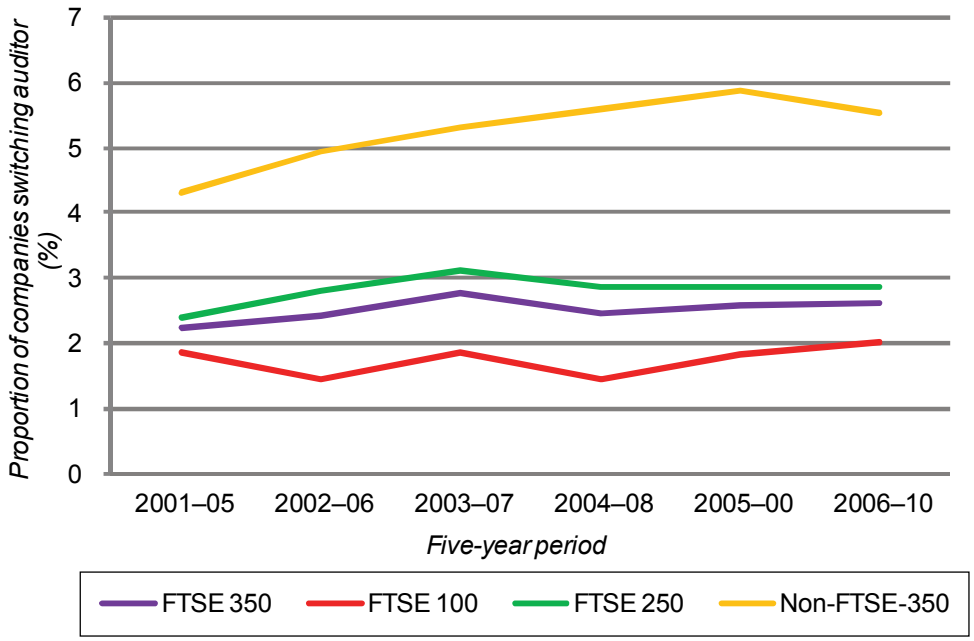
40. Figure 8 shows the proportion of companies that switched auditor over a five-year rolling period by index designations. Switching rates among non-FTSE-350 com-

[5] PwC stated that switching rates should therefore include Arthur Andersen switches.

panies were higher than switching rates among FTSE 100 and FTSE 250 companies over the whole sample period.

FIGURE 8

Five-year rolling switching rates by index designation



Source: CC analysis.

41. Table 4 shows the annual switching rates by index designations, 2001 to 2010. Among FTSE 350 companies, annual switching rates varied between 1.5 per cent and 3.5 per cent, with an average of 2.4 per cent between 2001 and 2010. This is lower than for non-FTSE-350 companies, which varied between 2.8 and 8.2 per cent.

TABLE 4 **Annual switching rates by index designation, 2001 to 2010**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
FTSE 350	2.7	1.5	3.0	2.6	1.5	3.5	3.2	1.5	3.2	1.7
FTSE 100	3.1	1.0	3.1	1.0	1.1	1.0	3.0	1.0	3.0	2.0
FTSE 250	2.5	1.7	2.9	3.3	1.7	4.5	3.3	1.6	3.3	1.6
Non-FTSE-350	5.2	4.2	4.1	3.3	4.8	8.2	6.0	5.5	4.5	2.8

Source: CC analysis.

Switching rates by type of event for FTSE 350 companies

42. The decision to switch auditor could be triggered for different reasons. A company might decide to switch auditor if it believes it is paying too high a fee, receiving too low a level of quality or for reasons of good corporate governance. A company may also change auditor due to external reasons (for example, the collapse of Arthur Andersen) or the desire for a single auditor after the merger of two companies with different auditors.

43. Using information contained in the public data set and information submitted by parties (see paragraph 59) we classified different types of switching event, namely:

(a) Andersen transaction: Arthur Anderson clients forced to change auditor after the collapse of the firm.

(b) M&A: where a change of auditor was associated with merger activity (see paragraph 45).

(c) From joint audit: where a company moved from having a joint audit to a single auditor.

(d) To joint audit: where a company moved from a single auditor to having a joint audit.

(e) All remaining events are defined as direct switching events (using the terminology adopted by PwC—see paragraph 59).

44. Categories *(c)* and *(d)* are primarily included for completeness. Moving to and from joint audit was sometimes related to merger activity, but the individual categorizations have been chosen based on what seemed most appropriate given the available data.

45. We adopted two different definitions for category *(b)*. The first is based on information submitted by the main parties about specific companies that changed auditor as a result of a takeover by a company that was not part of the public data set. We con-

sider that this definition could be restrictive (being limited to takeover by companies not in the database) and that firms may have incomplete information on such events. The second uses data on the annual value of merger activity for each company that was part of the FTSE 350 index at some point during 2001 to 2011.[6] Where a company had merger activity in the year of or the year before a switch of auditor we assume the merger activity to be associated with the switch. We note that this may overstate the extent of switching resulting from M&A activity as the data include all deals including small acquisitions of non-FTSE 350 companies that would have been unlikely to result in a FTSE 350 company reviewing its external audit appointment.

46. We consider the frequency of direct switching to be of most interest since these events are more likely: *(a)* to have been associated with a competitive tender for the engagement; and *(b)* to include events triggered by competitive market conditions or for reasons of corporate governance.

47. Tables 5 and 6 show the number of different switching events for FTSE 350 companies between 2001 and 2010 (reflecting the different definitions of M&A activity in paragraph 45), and the average switching rates over the period.

TABLE 5 **Analysis of FTSE 350 switching events, 2001 to 2010**

Switching event	*No*	*% of observations*
AA transaction	32	0.9
M&A	15	0.4
Direct switch	70	2.0
From joint audit	7	0.2
To joint audit	3	0.1

Source: CC.

[6] This data (complied by Dealogic), was provided by PwC.

TABLE 6 **Analysis of FTSE 350 switching events using more inclusive definition of M&A activity, 2001 to 2010**

Switching event	*No*	*% of observations*
AA transaction	32	0.9
Direct switch	52	1.5
M&A	31	0.9
From joint audit	7	0.2
To joint audit	3	0.1

Source: CC.

48. Tables 5 and 6 suggest that on average around 1.5 to 2 per cent of FTSE 350 companies have switched auditor each year (ie five to seven companies) excluding events related to the collapse of AA, moves to or from joint audits and events associated with merger activity. Tables 5 and 6 also suggest that (excluding changes of auditor in relation to the AA transaction) up to one-third of switches were associated with merger activity.

Switching rates between firms for FTSE 350 companies

49. There were 83 instances of FTSE 350 companies switching auditor in the period 2001 to 2010 excluding switching associated with the collapse of AA and moving to or from a joint audit.[7] Of these switches 82 per cent were from one Big 4 firm to another Big 4 firm and 13 per cent were from a non-Big-4 firm to a Big 4 firm. There were three instances of a company switching from a Big 4 firm to a non-Big-4 firm and one instance of a switch between non-Big-4 firms.

50. For these 83 switches, in Table 7 we show the proportion of engagements that switched between different auditor pairs. For this purpose we included switches to Arthur Andersen.

[7] In Table 5, the 83 instances of switching auditor are the direct switches and M&A switches (85) minus two instances of a company moving from a joint audit as a result of M&A activityfor which we do not observe a change of auditor in the public data set. In Table 6, the 83 instances of switching are the 52 direct switches and 31 switches associated with M&A activity.

TABLE 7 **Proportion of engagements won and lost between each firm, FTSE 350 engagements, 2001 to 2010**

per cent

Firm switched from	*Firm switched to*								
	PwC	*Deloitte*	*KPMG*	*E&Y*	*BDO*	*GT*	*AA*	*Other*	*Total*
PwC	-	10.8	9.6	8.4	1.2	1.2	2.4	0.0	33.7
Deloitte	10.8	-	0.0	0.0	0.0	0.0	0.0	0.0	10.8
KPMG	8.4	7.2	-	4.8	1.2	0.0	0.0	0.0	21.7
E&Y	6.0	4.8	7.2	-	0.0	0.0	1.2	0.0	19.3
BDO	0.0	1.2	0.0	0.0	-	0.0	0.0	0.0	1.2
GT	2.4	2.4	0.0	0.0	0.0	-	0.0	0.0	4.8
AA	0.0	0.0	0.0	0.0	0.0	0.0	-	0.0	0.0
Other	0.0	1.2	4.8	1.2	1.2	0.0	0.0	-	8.4
Total	27.7	27.7	21.7	14.5	3.6	1.2	3.6	0.0	100.0

Source: CC analysis.

51. For example, 33.7 per cent of switches were from PwC to another auditor and 27.7 per cent of switches to PwC from another audit firm. Deloitte had the largest net gain of engagements over the period: companies switched to Deloitte in 27.7 per cent of cases and switched from Deloitte in 10.8 per cent of cases (all switched to PwC).[8] All switches from BDO and GT were to either PwC or Deloitte.

Fees after switching auditor

52. For companies that switched auditor during the period for which data was collected we calculated the real percentage change in *(a)* the total audit fee and *(b)* the audit fee per £1 million turnover in the years after switching auditor.

53. We carried out this analysis first for all switching events excluding those associated with the collapse of AA and then for those events we identified as direct switching events.

54. This approach did not take into account changes in the overall fee level across all companies in a given year as the first year after switching auditor was not the same calendar year for all companies (eg first year after switching could be 2003 or 2009).

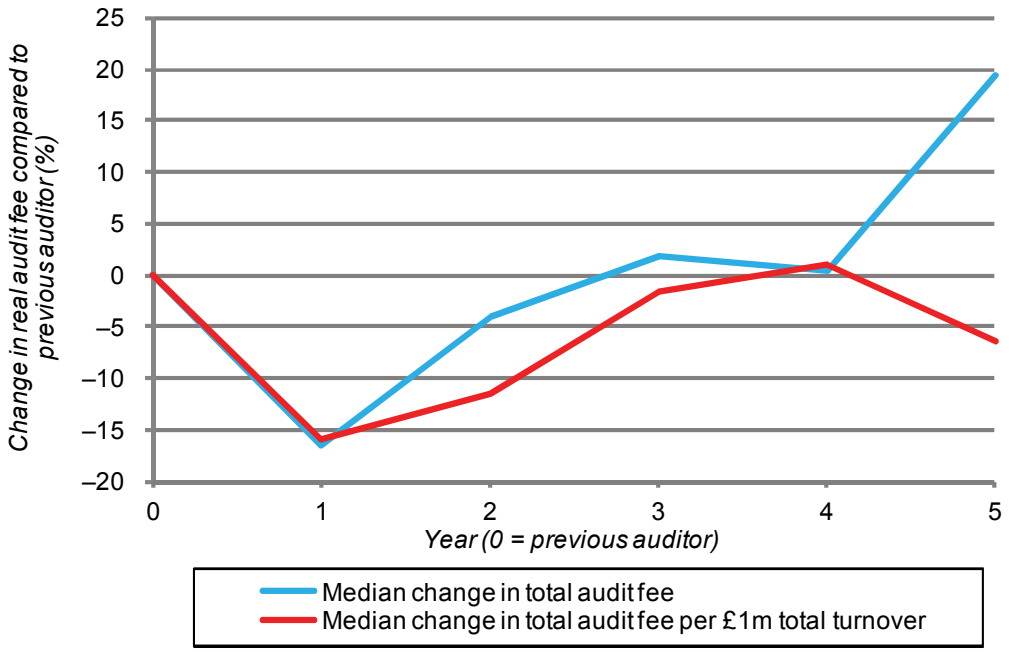
[8] We note that instances of switching from Arthur Andersen to Deloitte (and other firms) are excluded, therefore Deloitte's gain of clients was not driven by the collapse of Arthur Andersen.

55. When reporting figures for different index designations, results for each index will be based on results for only those years when the companies had the relevant index-ation. For example, a FTSE 350 company that was in the FTSE 350 when it switched auditor and for two years after switching auditor would be included in the calculations for year one and year two (for FTSE 350 companies). If this company dropped out of the FTSE 350 for year three it would not be included in the calculations for year three for FTSE 350 companies.

56. Figure 9 shows the median real percentage change in the audit fee and audit fee per £1 million turnover compared with the previous auditor's fee in the years after switch-ing auditor for FTSE 350 companies. Year 0 is the last year the previous auditor conducted the audit. Years 1 to 5 are the years the new auditor conducted the audit.

FIGURE 9

Real change in audit fee in years 1 to 5 after switching compared with the year before switching, FTSE 350 companies



Source: CC analysis.

57. Table 8 reports statistics on the observed real changes in audit fee and audit fee per £1 million turnover in the five years after switching. We report the number of com-

panies the statistics are based on, the aggregate real change in audit fee across all companies and the median, mean, minimum and maximum real changes in audit fee. We also report the proportion of companies for which the audit fee in the given year after switching is lower, in real terms, than the audit fee in the year before the switch.

TABLE 8 **Range of real changes in audit fee and audit fee per £1 million turnover in the years after a switch, FTSE 350 companies**

per cent

	Year after switching				
	1	*2*	*3*	*4*	*5*
Real change in audit fee					
No	66	49	37	30	23
Aggregate change across all companies	–19	–6	4	12	44
Individual company changes:					
Median	–17	–4	2	0	19
Mean	–8	3	20	28	61
Min	–86	–89	–63	–58	–97
Max	218	275	192	275	720
Lower fee than previous auditor	74	65	49	50	39
Real change in audit fee per £1 million real total turnover					
No	62	46	33	27	21
Aggregate change across all companies	–18	–10	–1	–7	11
Individual company changes:					
Median	–16	–11	–2	1	–6
Mean	2	23	46	91	44
Min	–93	–91	–72	–69	–80
Max	448	1,243	1,004	2,070	594
Lower fee than previous auditor	65	63	52	48	57

Source: CC.

58. Figure 9 and Table 8 indicate that audit fees generally decreased in real terms the year after a switch and returned to the previous fee level in the third year after switching: the median company obtained a 17 per cent real decrease in fee in the first year after switching and had a 2 per cent real increase (compared with the previous fee) in the third year. There was considerable variation in the changes of audit fee: in the first year after switching fee changes ranged in real terms from an 86 per cent decrease to a 218 per cent increase. 74 per cent of companies obtained a real decrease in audit fee. We note that this approach did not control for other observable factors which determined the audit fee, for example, scope and complexity of the audit, although we did consider turnover as a proxy for these factors.

59. PwC submitted additional analysis on the change in audit fee after switching.[9] Using its own market intelligence PwC classified switching events into different categories:

(a) Direct switches: where a company made a direct decision to switch unrelated to factors outside of the audit engagement. For example, due to reasons of corporate governance or dissatisfaction with the existing auditor.[10]

(b) Consequential switches: where a company changed its auditor as a consequence of another decision. The specific examples considered by PwC were (i) auditor switches after the collapse of Arthur Andersen; and (ii) switches following a situation where one company was taken over by another company that was not in the data set (but where the original company remained in the data set following the takeover).

(c) Tenders without switches: while not instances of switching, the competitive pressures brought to bear in these situations are very similar to those which arise with direct switches.

60. PwC told us that price changes following a switch should be assessed based on what is observed from direct switches and tenders without switches only, because in both circumstances the company has voluntarily and directly decided to tender its audit without other factors influencing its tendering decision.[11]

61. PwC calculated a 15 per cent median real decrease in audit fee following a direct switch and a 3 per cent median real price increase after a tender without a switch.

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[9] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/descriptive_statistics_pwc.pdf.

[10] We note that PwC was not able to observe directly the reasons for the companies switching auditor on these occasions. Rather this category is defined by excluding events associated with the collapse of AA and merger activity.

[11] According to PwC, a consistent answer to the question of the price response to a tender, whether or not there is a subsequent switch, can only be obtained if consequential tenders driven by external factors such as the Andersen collapse and company takeover activity are excluded. In the case of Arthur Andersen, this is because of the unique nature of the situation: in some instances, companies may have used the situation to negotiate aggressive fee reductions, whilst in others, companies may have considered themselves to be in a weak bargaining position given the speed and nature of the events that unfolded. In the case of company takeover activity, price changes post-switch are driven primarily by scope changes and other factors rather than the effects of competitive pressure exerted by tender. Excluding these situations focuses the analysis on those tenders and switches that come about because of deliberate, voluntary and direct decisions by the company to tender and (in many cases) to switch.

The results of the PwC analysis are shown in Table 9 below. However, PwC noted that simple descriptive statistics can be highly misleading as they do not control for the many factors that affect the audit fee, including changes in audit scope, complexity or risk.

TABLE 9 **PwC analysis of the real changes in audit fee after a tender or a switch, FTSE 350 companies, 2000 to 2011**

Switching event	*No*	*Median %*	*Mean %*
Direct switches	78	–15	–4
Consequential switches—Takeovers	12	–30	–1
Consequential switches—Andersen	30	3	6
Tenders without switches	28	3	81*
All switches	120	–3	–1
All switches (excluding Andersen)	90	–16	–3
Direct switches + tenders without switches	106	–6	19

Source: PwC analysis.

*The figures are based on the public data set and the observation for Thomas Cook has been found to be erroneous. When this observation is omitted, the mean price change for a tender no switch is 21 per cent.

62. Using the information provided by PwC and other main parties we calculated the real change in audit fee in the years after each type of switching event as described in paragraph 43, and for the 33 instances of a tender being held without a switch. In Table 10 the instances of switching that occurred as a result of a takeover are those identified by the main parties. However, unlike PwC the direct switching events do not include those related to moves to or from joint audits.

63. Table 10 shows the real change in audit fee in the first year after each type of switching event. The number of observations for each type of event that the calculations are based on is lower than the numbers presented in Tables 5 and 9 above. This is due in some cases of missing data on fees and that we only consider switches where the company was FTSE 350 at the time of the switch and in the year after the switch (see paragraph 55). We report the number of companies (for which fee data is available), the median change, the minimum and maximum percentage changes, and the proportion of companies which obtained a real fee decrease.

TABLE 10 **Real changes in audit fee after the first year of a tender, FTSE 350 companies**

	No	*Median %*	*Min %*	*Max %*	*% of companies obtaining a lower fee*
AA transaction	21	2	–89	195	48
M&A	11	–2	–86	218	55
Tender & no switch	29	2	–38	198	48
Direct switch	55	–17	–84	141	78
From joint audit	6	14	–37	2,101	33
To joint audit	1	540	540	540	0

Source: CC.

64. We observe a median real decrease in audit fee after a direct switch by a FTSE 350 company of 17 per cent and that a tender where the incumbent retained the audit resulted in a small real increase of 2 per cent. 78 per cent of these direct switchers obtained a reduction in fee, compared with 48 per cent of those which tendered but did not switch.

65. In Table 11 we consider direct switches only. We report the same statistics as in Table 10 but report for the five years after the switch occurred. It is important to note that the sample of companies decreases for later years after a switch.

TABLE 11 **Real changes in total audit fee in the years after a 'direct' switch, FTSE 350 companies**

per cent

	Year after switching				
	1	*2*	*3*	*4*	*5*
Number	*55*	*43*	*31*	*24*	*19*
Median	–17	–4	2	5	21
Min	–84	–89	–63	–33	–43
Max	141	150	100	275	720
% companies less than original fee	78	67	48	46	32

Source: CC.

66. We observe that compared with the previous fee, the audit fee starts to recover to its original level after the first year: by the third year after a switch the median fee change is a 2 per cent real increase compared with a 17 per cent real decrease in the first year, and the proportion of companies with a fee lower than the original fee is

48 per cent compared with 78 per cent in the first year. It should be noted that we do not control for material changes in the scope of the audit which may also impact on audit fees over time.

67. In Table 12 we report results using the alternative definition of merger activity, whether a company had any deal activity in the year before or the year of a switch (see paragraph 45). Table 12 shows the real changes in audit fee in the first year after a direct switch or a tender and no switch both where the event is, and is not, associated with merger activity. We report the median change, minimum and maximum changes and the proportion of companies that obtained a real fee decrease. As above the analysis is for FTSE 350 companies only.

TABLE 12 **Real changes in audit fee after the first year of a tender, FTSE 350 companies**

	No	*Median %*	*Min %*	*Max %*	*% of companies obtaining a lower fee*
Direct switches using wider definition of switching associated with M&A activity	39	–23	–86	218	79
Direct switches as defined in Table 10 associated with wider definition of M&A activity	27	–8	–82	141	67
Tender & no switch using wider definition of events associated with M&A activity	12	3	–36	169	50
Tender & no switch as defined in Table 10 associated with wider definition of M&A activity	17	2	–38	198	47

Source: CC.

68. We observe that, regarding direct switches, where a FTSE 350 company had deal activity in the year before or the year of the switch the median fee reduction was considerably smaller than where there was no such activity (8 per cent compared with 23 per cent reduction). There was also a smaller proportion of companies achieving a fee reduction (although the proportion is still high at 67 per cent). There do not appear to be no such differences when a company tenders and does not switch.

Auditor tenure

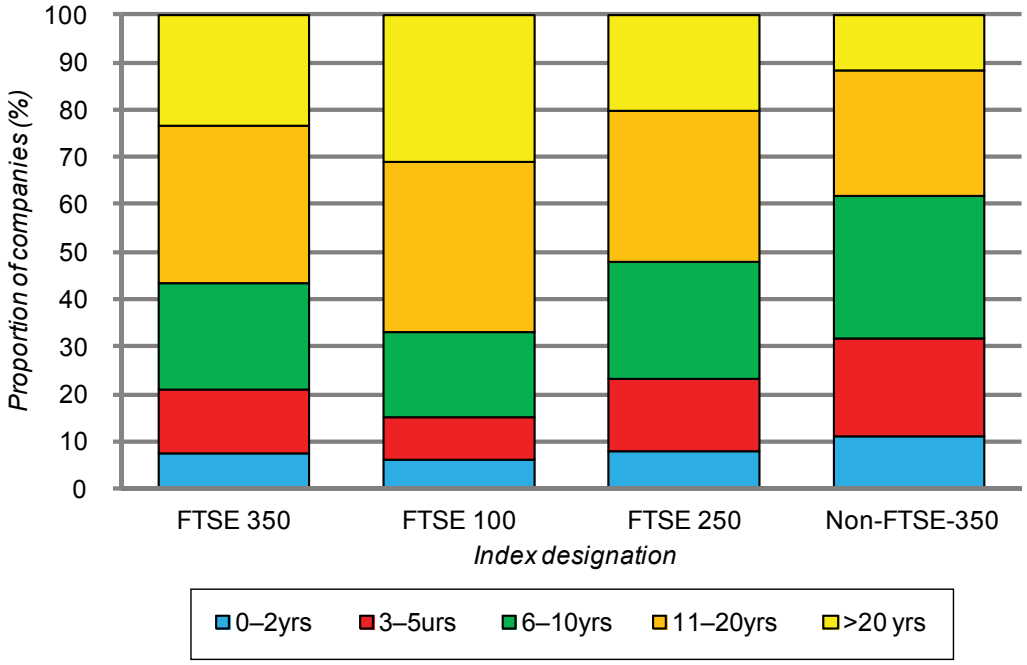
69. We only considered the tenure of a company's current auditor. Tenure was calculated as the difference between the most recent year for which data was submitted and the year of initial engagement provided by the parties. Where the year of initial engagement was missing, we assumed it to be either the first year for which data was submitted or the year 2000 where data was submitted for each year. Some companies had the year of initial engagement recorded as 'pre-' a certain date (eg pre-1990). In this situation the year was taken as a lower bound on tenure. We recognize that these two issues could lead to tenure being underestimated. We estimated that approximately 10 per cent of companies in the tenure calculations could be affected by these issues.[12]

70. Tenure was split into five bands: 0–2 years, 3–5 years, 6–10 years, 11–20 years and more than 20 years. Figure 10 shows the distribution of auditor tenure for each index designation. A company is categorized in the index designation it belonged to in 2010, and tenure is calculated as at 2010.

[12] A much larger number of companies had missing year of initial engagement data. Of 653 companies considered in 2010, 24 per cent had missing data and 4 per cent had 'pre-' a certain year. The effect of this reduced due to companies that have changed auditor as we only consider the tenure of the existing auditor.

FIGURE 10

Tenure of current auditor by index designations



Source: CC analysis.

71. Bearing in mind the assumption described in paragraph 69, the tenure of the current auditor decreased moving from FTSE 100 companies to FTSE 250 companies to non-FTSE 350 companies. For approximately 67 per cent of FTSE 100 companies the current auditor has audited the company for over ten years, compared with 52 per cent of FTSE 250 companies and 38 per cent of non-FTSE-350 companies. We also calculated that 31 per cent of FTSE 100 companies had audit engagements exceeding 20 years compared with 20 per cent of FTSE 250 companies.

72. We note that Figure 10 calculates the tenure of those companies in the FTSE 350 index in 2010. In section four (see paragraph 139) we consider companies that have been in the FTSE 350 index for at least ten years and find that tenure for these more established FTSE 350 companies is longer than that implied in Figure 12.

73. GT and BDO said that the CC's calculation of tenure was incompatible with the observed switching rates between audit firms. In particular, that the observed switching rates suggested much longer tenures. We consider that our estimates of tenure and an inferred average tenure length based on switching rates are not directly comparable: we consider the tenure of the existing auditor only and therefore these engagements by definition are not 'completed'.

74. We calculated tenure excluding companies which had missing data. Approximately 10 per cent of observations potentially had an underestimate of current auditor tenure. We calculated no substantial difference in the distribution of existing auditor tenures excluding these observations. The category '11–20' years was the most affected (lower than in Figure 10).

75. Oxera submitted analysis that examined the relationship between observed switching (or tendering) rates and the length of time between changes in a company's auditor (or the length of time between tenders). Oxera's analysis suggested that given an observed switching rate of X per cent, the *minimum* average tenure of an auditor is (1/X)*100 years. Our view is that whilst this may be a reasonable approach to estimating tenure, under certain assumptions, we do not consider this to be a reliable approach in this case. In particular, we cannot be certain that the observed level of switching over the last ten years is reflective of rates over a longer period, or that distribution of tenure would remain stable over time. Our analysis does not rely on calculations of average tenure. We consider the results on the instances of tenures longer than 5, 10 and 20 years.

Section 2—Results derived from the engagement data set

76. The engagement data set is confidential to individual audit firms and is not therefore published. The data is recorded for each engagement for the financial year of the

audit firm and only relates to work conducted by the UK member of the audit firm. This is in contrast to the public data set where data is recorded for each company financial year and (unless specified) relates to all company operations. The main difference is observed in the recording of the audit fee. In the public data set the audit fee is the total audit fee paid by the company (including all overseas audit work) for the company's financial year. In the engagement data set the audit fee is the audit fee earned by the UK part of the audit firm in the firm's financial year (which may be fee earned across two audits depending on the differences in company and audit firm financial year ends).

77. In the engagement data set all engagements that recorded total hours as missing, zero or negative were excluded. This accounted for 651 engagements (14 per cent of the total sample). We also excluded observations where the UK audit fee (net of international costs) was missing or negative. This accounted for a further 44 engagements (1 per cent of the total sample). Lastly, we excluded engagements which recorded negative hours or scale rates for any grade of staff. This accounted for a further 32 engagements (0.7 per cent of the total sample). These exclusions left a sample of 3863 engagements on which to base the statistics.

78. Statistics reported annually are reported for the year in which the audit firms' financial year ends. Audit firms had different year ends: Deloitte—31/05, PwC and GT—30/06, BDO and KPMG—30/09.

79. All engagement financial information was deflated to March 2005 prices using the CPI (see paragraph 12). Company status and industry classification were taken from the public data set (see paragraphs 13 and 14).

Staff ratios

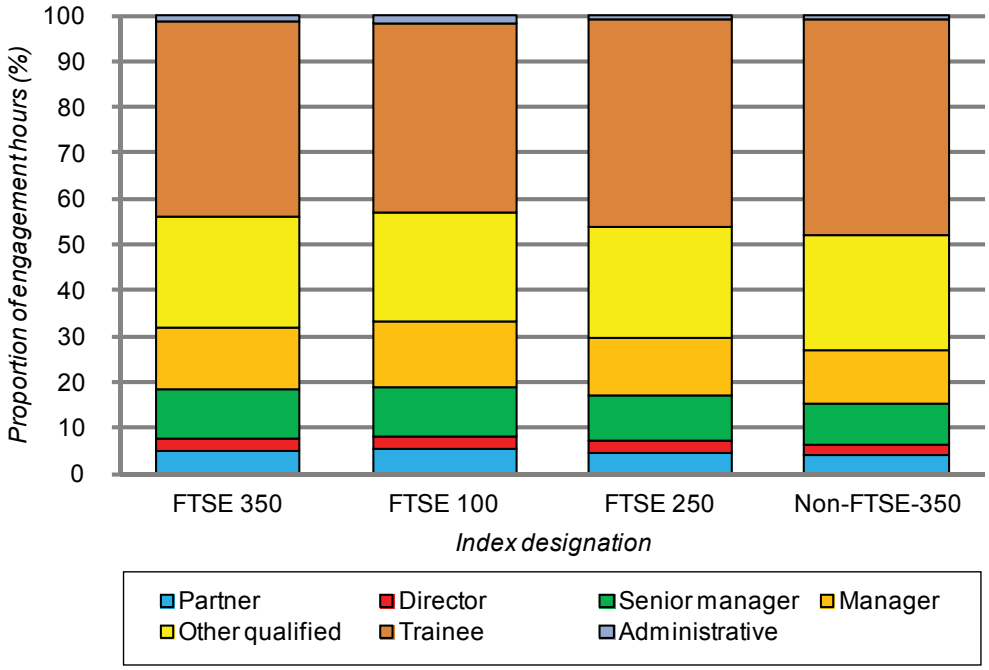
80. We calculated the proportion of staff hours and staff costs allocated to audit engagements accounted for by each grade of staff across all engagements by index designation and audit firm.

81. The total number of hours worked by each grade was taken directly from data provided by the parties. Staff costs for an engagement were calculated as the number of hours for each grade multiplied by the scale rate provided for that grade by the parties. This measure of staff costs is different from the salary costs of audit staff as the scale rate includes a mark-up over the salary costs. Staff costs based on salaries were submitted by parties but these did not include costs for partners.

82. Figure 11 shows that FTSE 350 engagement teams tend to have a more senior profile than other listed and private engagement teams, and FTSE 100 engagements have more senior teams than FTSE 250 engagements. The proportion of hours accounted for by partners, directors and senior managers was 18.9 per cent among FTSE 100 engagements, 17.1 per cent among FTSE 250 engagements and 15.2 per cent among non-FTSE-350 engagements.

FIGURE 11

Proportion of engagement hours by staff grade by index designation 2011

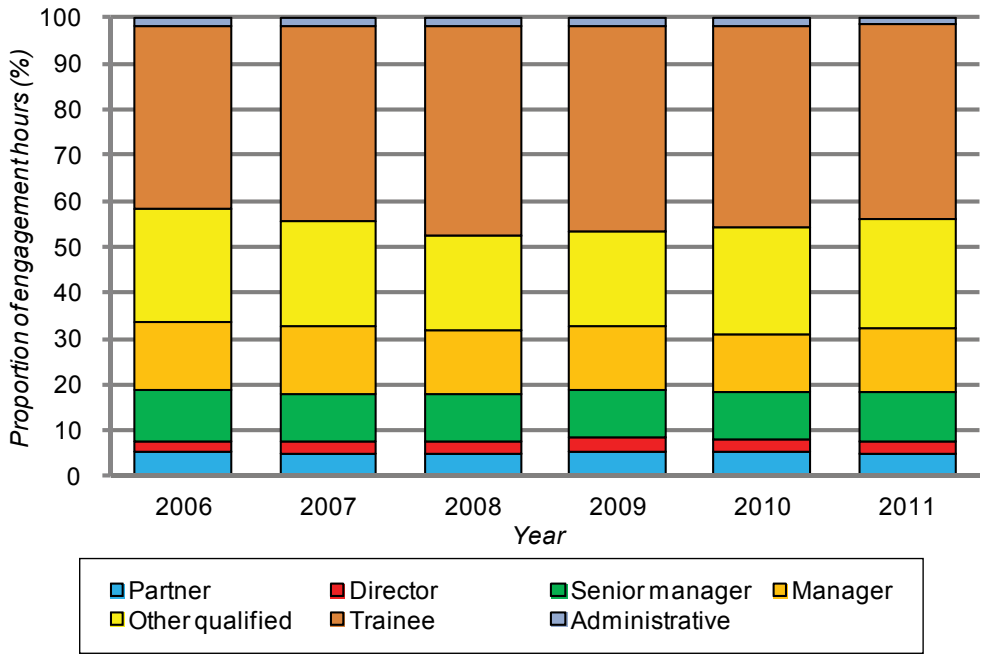


Source: CC analysis.

83. Figure 12 shows that among FTSE 350 engagements the proportion of engagement hours accounted for by partners has stayed largely constant at approximately 5 per cent between 2006 and 2011.

FIGURE 12

Proportion of engagement hours by staff grade, FTSE 350 engagements, 2006 to 2011



Source: CC analysis.

84. Figure 13 shows the proportion of FTSE 350 engagement hours by staff grade for each audit firm in 2011.

FIGURE 13

Proportion of total FTSE 350 engagement hours by staff grade in 2011

[✂]

Source: CC analysis.

85. For all audit firms trainee staff accounted for the highest proportion of engagement hours of any grade. Partner time accounted for approximately 5 to 6 per cent of engagement hours.

86. Figure 14 below shows the proportion of engagement staff costs (calculated using the scale rate as a measure of the hourly cost of each staff grade) accounted for by each grade across audit firms' FTSE 350 engagements in 2011.

FIGURE 14

Proportion of total FTSE 350 engagement staff cost by grade in 2011

[✂]

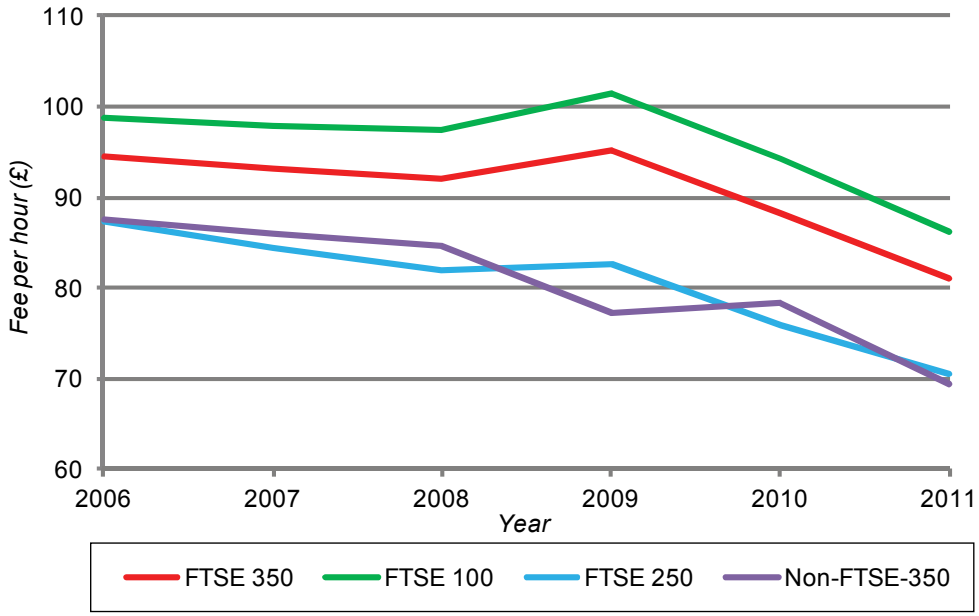
Source: CC analysis.

Audit fee per hour

87. Figure 15 shows the annual UK audit fee (in March 2005 prices) (net of any international costs) per hour charged (by all staff grades) across all engagements by index designation.

FIGURE 15

Annual fee per hour (March 2005 prices) by index designation



Source: CC analysis.

88. FTSE 100 engagements achieved the highest fee per hour. This result is consistent with observations on the grade mix of the audit teams for these engagements (see Figure 11 and paragraph 83). Within each index designation we observe declining fees per hour between 2006 and 2011, in real terms.

89. Table 13 reports further results for FTSE 350 engagements. Considering individual engagements,[13] we calculated that the average number of FTSE 350 engagement hours has decreased by 4 per cent between 2006 and 2011 (10,895 to 10,426) and the average fee per hour has decreased in real terms by 19 per cent over the same period (£102 per hour to £83 per hour in March 2005 prices).

TABLE 13 **Annual engagement hours and fee per hour (March 2005 prices), FTSE 350 companies**

	2006	*2007*	*2008*	*2009*	*2010*	*2011*
Hours (n)						
Average	10,895	11,033	10,466	10,089	9,951	10,426
5th percentile	253	324	323	272	271	231
95th percentile	29,924	35,998	34,180	34,137	33,743	35,336
Fee per hour (£)						
Average	102	95	90	93	85	83
5th percentile	52	46	48	48	41	40
95th percentile	160	176	143	163	141	130

Source: CC.

90. Figure 16 shows the annual audit firm fee per hour (in March 2005 prices) for FTSE 350 engagements by firm. This shows variation in the fee per hour achieved by different audit firms. All audit firms experienced a real decrease in their fee per hour in 2011 compared with the level in 2008. [✂] had the lowest real audit fee levels across 2007 to 2011.

FIGURE 16

Audit fee per hour, FTSE 350 engagements by firm (March 2005 prices)

[✂]

Source: CC analysis.

Audit fee per hour after switching auditor

91. The fee per hour was calculated in the year preceding a switch of auditor and in years after the switch across all engagements. Details of switching events were taken from the public data set and matched (using the name of the company) to the

[13] In Table 13, we report the average engagement fee per hour. This differs from Figure 15, where we compare the aggregated fees across engagements to the aggregated hours across engagements to calculate fee per hour.

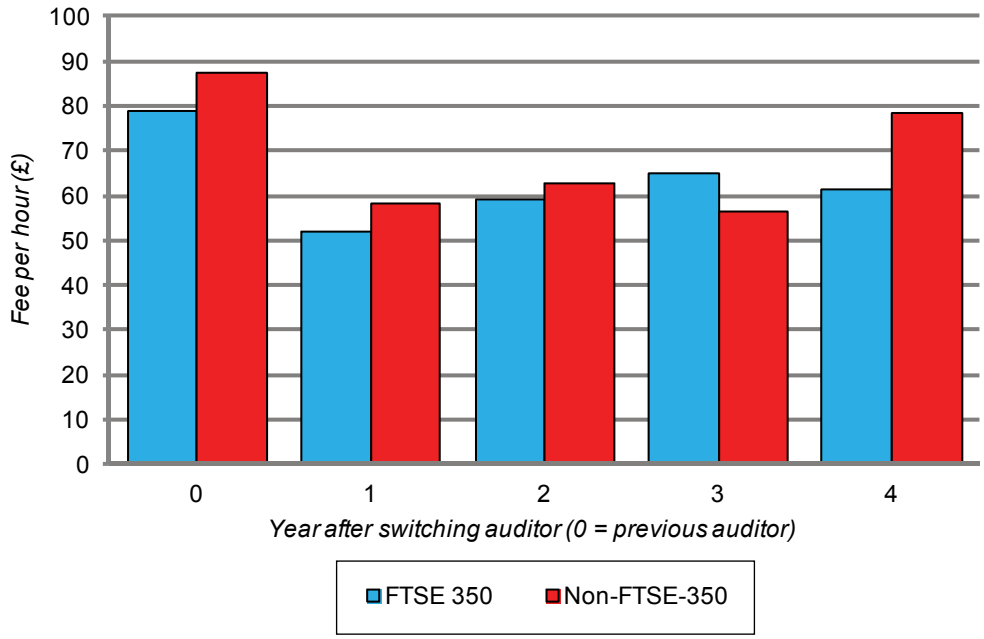
relevant audit firm's engagement data. The year before switching was taken as the audit firm's financial year that ended *before* the financial year start of the year in which a company switched auditor. The first year after switching was taken as the new audit firm's financial year that started *after* the financial year start of the year in which a company switched auditor.

92. When investigating the change in fee per hour by index designation we considered only engagements for companies that were in the index for the entire period under analysis (see paragraph 55). We did not make a distinction between different types of switching event due to the small number of observations.

93. Figure 17 shows the audit fee per hour (in March 2005 prices) in the year before switching auditor and in the years after switching auditor for FTSE 350 and non-FTSE-350 engagements.

FIGURE 17

Audit fee per hour (March 2005 prices), all engagements in years before and after switching auditor



Source: CC analysis.

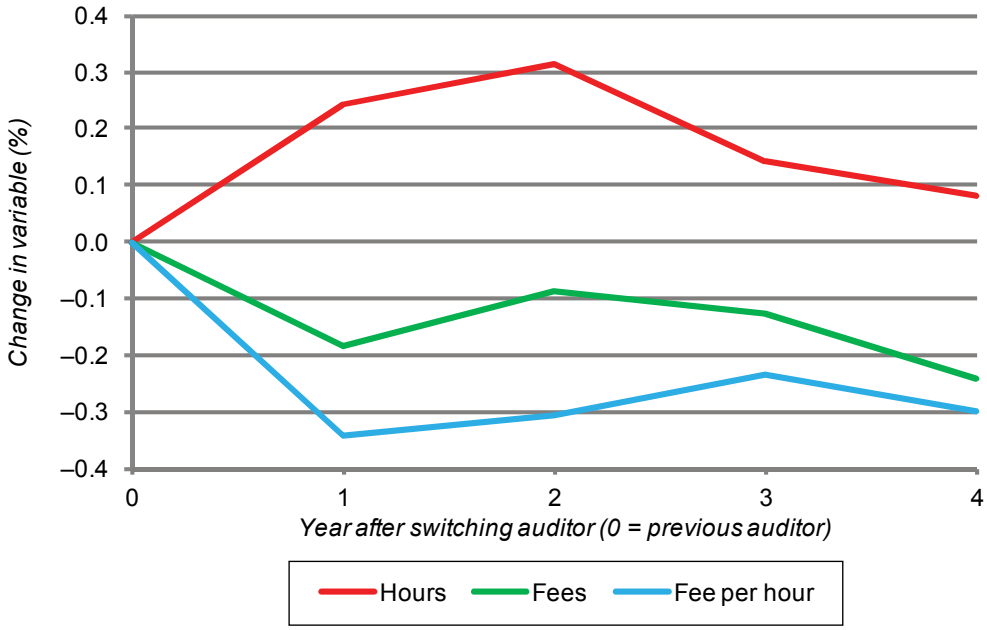
94. For both FTSE 350 and non-FTSE-350 engagements the fee per hour decreased in real terms in the years after switching auditor.

95. PwC and KPMG highlighted limitations in comparing the fee per hour before and after a tender. In relation to interpreting average audit fees per hour, KPMG said that the scope of the audit would change over time and that the composition of the engagement team and mix of different grades would change over time by virtue of learning by doing and other efficiencies. PwC said that in situations where audit fee and scope are unchanged following a switch of auditor, audit fee per hour would still be expected to fall initially as the incoming auditor typically has higher hours in the first year of an audit (but does not charge all of these hours), and as the auditor becomes more efficient and familiar with the company hours will tend to fall and fee per hour will tend to recover.

96. In response to this comment, we calculated the change in hours, the change in audit fee and the resulting change in audit fee per hour aggregated across all companies after a switch for FTSE 350 companies and the share of engagement hours for each grade of staff before and after a switch. These are shown in Figures 18 and 19.

FIGURE 18

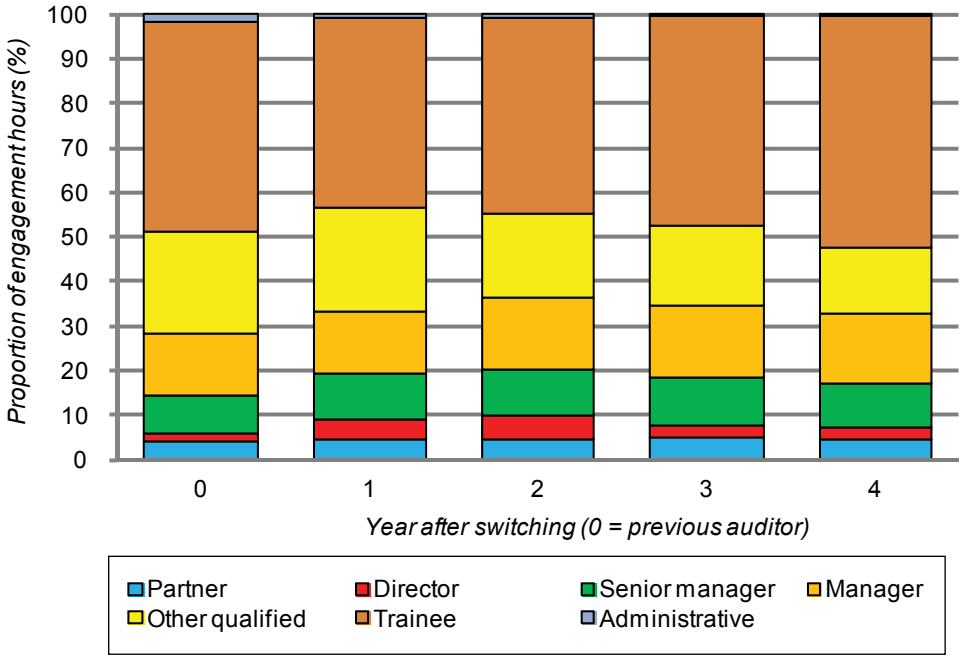
Analysis of audit fee per hour, FTSE 350 engagements in years before and after switching auditor



Source: CC analysis.

FIGURE 19

Share of hours by grade, FTSE 350 engagements in years before and after switching auditor



Source: CC analysis.

97. In the year after switching we observed a real decrease in the level of audit fee of approximately 18 per cent and a larger increase in the number of hours of approximately 24 per cent. We also observed an increase in the seniority of the engagement team in the year after a switch, with an increase in the proportion of engagement hours attributed to partners, directors and senior managers.

Scale rates

98. Figure 20 shows the partner scale rate across all engagements for FTSE 350 and non-FTSE-350 engagements for each audit firm in 2011.

FIGURE 20

Partner scale rates, by index designation 2011

[✂]

Source: CC analysis.

99. [✂] had the largest partner scale rates within each index designation and [✂] the lowest scale rates. PwC noted that the figures were the UK average scale rate, which vary by region and specialism.

Revenue recovery rate

100. Revenue recovery rate (RRR) was a metric used by audit firms to assess the relative profitability of engagements within a firm, which we sought to replicate across all engagements for each firm. The RRR compared a measure of staff cost of all engagements (see paragraph 81) to the total UK audit fees (net of international costs) earned across engagements.

101. Figure 21 shows the annual audit firm RRR across all FTSE 350 engagements.

FIGURE 21

Annual audit firm revenue recovery rate, FTSE 350 engagements, 2006 to 2011

[✂]

Source: CC analysis.

102. [✂] achieved a substantially higher RRR than other audit firms throughout the period 2006 to 2011. [✂] had the lowest RRR throughout the period. We note, however, that the RRRs across audit firms are not directly comparable due to differences in approaches to determining scale rates (see Appendix 14, paragraphs 9 and 10). All audit firms saw a decrease in RRR from 2010 to 2011.

103. Audit firms achieved varying recovery rates across engagements. Table 14 provides for each audit firm the median, mean and the 5th and 95th percentile (a measure of the smallest and largest recovery rates excluding outliers) recovery rates achieved on FTSE 350 engagements in 2011. PwC had a difference of approximately 40 per cent between the 95th and 5th percentiles. This difference was approximately 30 per cent for Deloitte, [✂] per cent for KPMG and [✂] per cent for EY.

TABLE 14 **Variation in firm recovery rates of FTSE 350 engagements 2011**

	N	*Median*	*Mean*	*5th percentile*	*95th percentile*
PwC	[✂]	[✂]	[✂]	[✂]	[✂]
KPMG	[✂]	[✂]	[✂]	[✂]	[✂]
Deloitte	[✂]	[✂]	[✂]	[✂]	[✂]
E&Y	[✂]	[✂]	[✂]	[✂]	[✂]
BDO	[✂]	[✂]	[✂]	[✂]	[✂]
GT	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC.

Section 3—Movements between index designations

104. In this section, we first consider the movements of companies between index designations. Secondly, we consider the association between companies moving between index designations, companies switching auditor and companies being involved in M&A activity.

Frequency of movements

105. We used data for 452 companies for which we had at least ten years of data. The restriction for at least ten years of data was made to have a consistent timeframe of suitable length to assess the movements of companies between index designations.[14] We considered index designation changes for companies between quarters. We considered movements between the FTSE 350 index, other listed status and private status. We use this distinction here as we do not make comparisons between index designations as in section 1 and section 2 above (see paragraph 13). Based on the company status in the first recorded quarter: approximately 55 per cent of companies were FTSE 350, 34 per cent were other listed and 10 per cent were private.

106. Table 15 shows the number of changes between FTSE 350, other listed and private index designations for each company during this time. Approximately one-third of companies remained in the same index designation throughout the period. Approximately another third of companies changed index designation only once. In total, approximately 66 per cent of companies changed index designation at least once during the period.

TABLE 15 **Number of changes in index designation**

	0	*1*	*2*	*3*	*4*	*5*	*6*
Number of changes	154	133	82	51	24	6	2
Proportion of companies (%)	34.1	29.4	18.1	11.3	5.3	1.3	0.4

Source: CC.

107. Of the 154 companies that remained in the same index designation, 147 (33 per cent of the total sample) were always part of the FTSE 350 index.[15] Table 16 shows that within this group of companies: 31 per cent were always in the FTSE 100, 33 per

[14] For example, some companies have only 1, 2 or 3 years worth of observations—it would be misleading to conclude on the number of index designations at these companies alongside other companies with a longer time frame.
[15] We would expect this as the data request was for companies that had been part of the FTSE 350 index during 2001–2011. The other 7 companies may not have been identified as being part of the FTSE 350 index at any time due to some aspect of the CC's data-cleaning process.

cent were always in the FTSE 250 and 20 per cent moved both from the FTSE 250 into the FTSE 100 and vice versa. 12 per cent moved only once from the FTSE 250 to the FTSE 100 and 5 per cent moved only once from the FTSE 100 to the FTSE 250.

TABLE 16 **Companies that have always been in the FTSE 350**

	Number of companies	*Proportion of companies %*
FTSE 350 only	147	100
FTSE 100 only	45	31
FTSE 250 only	48	33
FTSE 250 to FTSE 100 (permanent)	18	12
FTSE 100 to FTSE 250 (permanent)	7	5
Movement between FTSE 100 and FTSE 250	29	20

Source: CC.

108. Table 17 shows the number of companies that moved between each index designation and the number of those companies that made the same movement more than once. For example, 207 (46 per cent) companies moved from other listed to FTSE 350 and 46 of these companies moved from other listed to FTSE 350 more than once.

TABLE 17 **Movement between Index designations**

	Number of companies	*Number of companies making the movement more than once*
Private to Other listed	22	0
Private to FTSE 350	29	0
Other listed to FTSE 350	207	46
FTSE 350 to Other listed	178	38
FTSE 350 to Private	39	1
Other listed to Private	21	0

Source: CC.

109. Table 17 also shows that the majority of movement into and out of the FTSE 350 index was with the other listed designation. Of the 236 companies that moved into the FTSE 350 index: 88 per cent moved from the other listed designation and 12 per cent were private companies.

110. Twenty-two companies moved from private to other listed designation. Twenty-one of these companies subsequently moved from the other listed designation to the FTSE 350 index (not shown in Table 17, but these companies are part of the 207 companies that moved from the other listed designation to the FTSE 350). We calculated that 207 companies moved into the FTSE 350 index from the other listed designation and 178 companies moved into the other listed designation from the FTSE 350 index. While not reported in Table 17, we calculated that 123 companies (27 per cent) had movements both into and out of the FTSE 350 index from the other listed designation.

Switching audit firm associated with listing and entering the FTSE 350

111. We identified instances of a company switching auditor in the years leading up to becoming a listed company and/or the years leading up to joining the FTSE 350 index. We do not make the restriction on the number of years of data made in the previous section (see paragraph 105), which gives a sample of 695 companies for the analysis below (the sample of companies that were part of the FTSE 350 index at some point between 2001 and 2011).

112. KPMG said that switches that coincided with movements in index designation could be a result of features that were correlated with the change in index designation, though not 'driven by' the movement.

113. We identified 208 instances (at 187 companies) of companies switching auditor (excluding instances of switching from Arthur Andersen and moving to/from a joint audit). For these 208 instances, Table 18 shows the index designations of the companies during the year they switched auditor: the majority of these companies switched auditor when they were either FTSE 250 or other listed companies.

TABLE 18 **Index designation in the year the company switched audit firm**

	FTSE 100	*FTSE 250*	*Other listed*	*Private*
Number	19	68	82	39
Proportion (%)	9	33	39	19

Source: CC.

114. Table 19 shows the proportion of these 208 events that were: between Big 4 firms (74 per cent); from a Big 4 firm to a Mid Tier firm (8 per cent); from a Mid Tier firm to Big 4 firm (15 per cent); and between Mid Tier firms (2 per cent). It also shows that, for example, 100 per cent of companies that switched audit firm in the year that the company was in the FTSE 100 switched from a Big 4 firm to another Big 4 firm.

TABLE 19 **Proportion of index designation switches between different audit firm types**

	Total number of switches	*Big 4 to Big 4 %*	*Big 4 to Mid Tier %*	*Mid Tier to Big 4 %*	*Mid Tier to Mid Tier %*
FTSE 100	19	100	0	0	0
FTSE 250	68	78	4	16	1
Other listed	82	65	13	20	2
Private	39	74	8	13	5
All	208	74	8	15	2

Source: CC.

115. In Table 20 we look at the proportion of switches that occurred in the year before, or the year in which a company moved index designation. In Table 21 we widen this period further to include up to two years before moving index designation to one year after.

116. When considering movements from the other listed designation to the FTSE 350 (and vice versa) and the FTSE 250 to FTSE 100, we considered separately the first occasion a company made the movement and other occasions on which a company made the movement (during the time period considered). It is likely to be of greater significance when a company moves into the FTSE 350 (or FTSE 100) for the first

time (although we note that approximately 64 per cent of companies made zero or one index movement (see paragraph 106).

117. For Table 20, where we consider the year before and the year of a change of index (a two-year period) of the 208 switches, 60 per cent did not coincide with a change of index designation, 30 per cent had one change and 10 per cent had two changes (between FTSE 100, FTSE 250, other listed and private designations). For Table 21, where we consider a wider period for the switch and change of index designation to occur (a four-year period), 44 per cent of switches did not coincide with a change of index designation, 38 per cent had one change and 14 per cent had two or more (a maximum of five) changes (between FTSE 100, FTSE 250, other listed and private designations).

TABLE 20 **Analysis of switches occurring in the year before or the year of a change of index designation**

	All Switches	*Big 4 to Big 4*	*Big 4 to Mid Tier*	*Mid Tier to Big 4*	*Mid Tier to Mid Tier*
Total number of switches	208	154	17	32	5
					per cent
No of index designation movements within switching period					
0	60	58	71	66	60
1	30	31	24	28	40
2	10	11	6	6	0
Index designation movement					
Private to Other listed	1.0	1.3	0.0	0.0	0.0
Private to FTSE 350	1.5	1.3	0.0	3.1	0.0
Other listed to FTSE 350 (1st occasion)	9.2	8.4	11.8	9.4	20.0
Other listed to FTSE 350 (other occasions)	1.9	2.6	0.0	0.0	0.0
FTSE 250 to FTSE 100 (1st occasion)	2.4	2.6	5.9	0.0	0.0
FTSE 250 to FTSE 100 (other occasion)	0.5	0.6	0.0	0.0	0.0
FTSE 100 to FTSE 250	3.9	5.2	0.0	0.0	0.0
FTSE 350 to Private	7.8	9.7	0.0	3.1	0.0
FTSE 350 to Other listed (1st occasion)	10.2	12.3	5.9	3.1	0.0
FTSE 350 to Other listed (other occasions)	5.8	4.5	5.9	12.5	0.0
Other listed to Private	5.3	4.5	5.9	6.3	20.0

Source: CC.

118. Table 20 also shows, for example, that 154 (out of 208) switches were from a Big 4 firm to another Big 4 firm. Of these 154 switches, 58 per cent were not associated with a change of index designation (between FTSE 100, FTSE 250, other listed and private designations), and of the 154 switches 1.3 per cent occurred in the year before or the year in which a company moved from being a private company to the other listed designation.

119. While not reported in Table 20, we calculated that 31 per cent of the switches considered were associated with movement into or out of the FTSE 350.[16]

120. A switch of auditor is more likely to be associated with a move 'down' an index designation (ie from FTSE 100 to FTSE 250, FTSE 350 to other listed or listed to private).

[16] This illustrates the impact of companies having more than one index designation movement around the time of the switch (as highlighted in paragraph 117): aggregating the proportion of switches associated with movements into or out of the FTSE 350 in Table 19 (1.5 + 9.2 + 1.9 + 7.8 + 10.2 + 5.8) equals 36.4 per cent, but given 10 per cent of switches were associated with two index designation movements we conclude that 31 per cent of switches were associated with (at least one) movement into or out of the FTSE 350.

TABLE 21 **Analysis of switches occurring in the two years before, the year after or the year of a change of index designation**

	All Switches	*Big 4 to Big 4*	*Big 4 to Mid Tier*	*Mid Tier to Big 4*	*Mid Tier to Mid Tier*
Total number of switches	208	154	17	32	5
					per cent
No of index designation movements within switching period					
0	44	42	53	50	40
1	38	38	41	41	40
2 or more	18	21	6	9	20
Index designation movement					
Private to Other listed	1.0	1.3	0.0	0.0	0.0
Private to FTSE 350	3.4	2.6	5.9	6.3	0.0
Other listed to FTSE 350 (1st occasion)	16.5	15.6	17.6	15.6	40.0
Other listed to FTSE 350 (other occasion)	5.3	6.5	0.0	3.1	0.0
FTSE 250 to FTSE 100 (1st occasion)	5.8	6.5	5.9	3.1	0.0
FTSE 250 to FTSE 100 (other occasion)	0.5	0.6	0.0	0.0	0.0
FTSE 100 to FTSE 250	4.9	6.5	0.0	0.0	0.0
FTSE 350 to Private	9.2	11.0	5.9	3.1	0.0
FTSE 350 to Other listed (1st occasion)	13.6	15.6	5.9	6.3	20.0
FTSE 350 to Other listed (other occasions)	8.3	7.8	5.9	12.5	0.0
Other listed to Private	6.3	5.8	5.9	6.3	20.0

Source: CC.

121. Table 21 tells a broadly similar story to Table 20, but noticeably more instances of switching are associated with index designation movements given the wider time frame considered. There is also a higher proportion of switches with more than one index designation move in the period around switching: 18 per cent of switches had two or more changes of index designation in the switching period considered. The main difference compared with Table 20 is that the proportion of Mid Tier to Big 4 switches associated with a move from the other listed designation to the FTSE 350 for the first time increased to 15.6 per cent from 9.4 per cent. While not reported in Table 21, we calculated that 45 per cent of the switches considered in the wider time frame were associated with movement into or out of the FTSE 350.

122. BDO told us that whether and when a listed company joins the FTSE 350 was not within its control as it depended on its market capitalization relative to other com-

panies. It therefore thought that a wider (two-year) time frame was a more appropriate length of time within which to review changes in auditors (ie Table 21 is more appropriate).

123. KPMG told us that there was no evidence to support the suggestion that there is institutional bias or external pressure on firms to switch to the largest four audit firms on entering the FTSE 350 given the CC found no causal relationship between changes of index designation and switching and that 60 per cent of switches did not coincide with a change of index (see paragraph 117). KPMG are correct that this analysis does not establish a causal relationship and that 60 per cent of switches were not associated with a change in indexation. Nevertheless we found that 9.2 per cent of switches were associated with a move from other listed to the FTSE 350 index for the first time and 1.5 per cent of switches were associated with a move from private to FTSE 350 (see Table 20). Of these events (22 switches), a Mid Tier firm was the incumbent auditor in five occasions and in four of these occasions the engagements was won by a Big 4 firm (a Big 4 firm was the incumbent auditor on 17 occasions and on 15 of these occasions another Big 4 firm won the engagement). The reasons why this might be the case is considered elsewhere.

Association of movements in designation, switching and merger activity

124. In Section 1 we looked at the association of switching by FTSE 350 companies with merger and acquisition activity (see paragraph 45). In this section, we expand this analysis to include all companies and to understand associations with movements in designation. The primary purpose of this was to ensure that we do not overstate the extent to which switching by FTSE 350 companies might have been the result of external factors (ie M&A activity and change in designation) given the potential for these circumstances to overlap.

125. In the sample of 695 companies (see paragraph 111) we calculated that 61 per cent engaged in deal activity in at least one year (see paragraph 45). We calculated that 36 per cent of companies engaged in deal activity in at least a quarter of the years in which they were active, 15 per cent of companies engaged in deal activity in at least half the years in which they were active and 7 per cent of companies engaged in deal activity in at least three-quarters of years in which they were active.

126. We calculated that of the 208 instances when a company switched auditor (excluding changes from Arthur Andersen and moving to/from a joint audit), 20 per cent occurred in the same year as some deal activity undertaken by the company and 27 per cent occurred with deal activity in the year before or year of a switch. Table 22 shows the proportion of switches where the company also engaged in deal activity in the years around the switch. For example, 33 per cent of switches occurred when there was merger activity in either the year before, the year of, or the year after the switch.

TABLE 22 **Analysis of switches associated with merger activity in the years around switching**

	All switches	*Big 4 to Big 4*	*Big 4 to Mid Tier*	*Mid Tier to Big 4*	*Mid Tier to Mid Tier*
Total number of switches	208	154	17	32	5
					per cent
Merger activity					
Year of switch	20	23	0	16	0
Year of switch/up to 1 year before switch	27	31	6	22	0
Year of switch/up to 2 years before switch	34	40	6	25	0
Year of switch/up to 3 years before switch	38	45	12	25	0
Year of switch/up to 1 year before switch/ up to 1 year after switch	33	37	6	31	0
Year of switch/up to 2 years before switch/ up to 1 year after switch	38	45	6	31	0
Year of switch/up to 3 years before switch/ up to 1 year after switch	43	50	12	31	0

Source: CC.

127. Table 22 also shows that switches between Big 4 firms were more likely to be associated with merger activity.

128. Table 23 shows the proportion of switches associated with a change of index designation in the year of or year after a switch, and merger activity in the year of or year before a switch.

TABLE 23 **Analysis of switches associated with a change of index designation in the year of, or year after a switch, and merger activity in the year of, or year before a switch**

Total number of switches	208
	%
Index designation movement	
Private to Other listed	0.0
Private to FTSE 350	0.0
Other listed to FTSE 350 (first occasion)	3.8
Other listed to FTSE 350 (other occasion)	0.0
FTSE 250 to FTSE 100 (first occasion)	1.0
FTSE 250 to FTSE 100 (other occasion)	0.0
FTSE 100 to FTSE 250	1.9
FTSE 350 to Private	2.4
FTSE 350 to Other listed (first occasion)	1.9
FTSE 350 to Other listed (other occasions)	1.4
Other listed to Private	0.5

Source: CC.

129. The proportion of switches that coincided with deal activity before the switch and an index designation move after the switch is low. We calculated that 3.8 per cent of switches coincided with deal activity and a move from other listed status to the FTSE 350 index (for the first time). We also calculated that 2.4 and 0.5 per cent of switches were preceded by deal activity and followed by a move to private status from the FTSE 350 index and other listed status respectively.

130. We also considered switches by FTSE 350 companies only: of 83 instances of a FTSE 350 company switching auditor between 2001 and 2010, in 22 per cent of cases the company moved into the FTSE 350 in the year before, or the year of the switch (we note that the company may have previously been in the FTSE 350). Of the 18 FTSE 350 switches where the company moved into the FTSE 350 in the year before, or the year of the switch we calculated that 10 switches had deal activity in the year before, or the year of the switch.

Section 4—characteristics of long audit tenure companies

131. In this section we look at the characteristics of companies that used the same audit firm for at least ten years and whether these characteristics differ from companies that did switch audit firm in this period. We used data provided by the public and engagement data sets.

132. The evidence suggests that certain observable characteristics of a company may be associated with not having switched audit firm for a long time, for example the size of a company and the complexity of the audit (measured by the number of countries requiring an audit and the number of partners on the UK audit team).

133. The evidence also suggests that companies that were audited by a Big 4 firm were less likely to switch audit firm. PwC said that this finding reflected the fact that companies would not switch if they were currently obtaining a high quality and competitively priced audit and that the chances of this occurring are greater when companies use a large audit firm. KPMG told us that this finding was likely to be driven by the underlying quality and value for money of the audit services received, rather than by the identity of the audit firm per se or its previous length of tenure. We note that while this explanation is consistent with the finding that companies with a Big 4 audit firm were less likely to switch audit firm, it is not the only interpretation of this observation.

134. We analysed the sample of 519 companies which were part of the FTSE 350 at some point in the period 2001 to 2011 or the Top Track 100 at some point in the period 2006 to 2011 and for which we had data for ten years. Of these companies, 347 (67 per cent) did not switch auditor during the ten-year period.[17]

[17] Unlike in the first CC survey we were unable to distinguish cases where a company had tendered and stayed with the audit firm. See Appendix 3.

Descriptive statistics

135. We calculated a number of contingency tables between company characteristics and an indicator of a company not switching in the last ten years and calculated the Pearson's chi-squared statistic[18] to test for an association between the variables. We report key results below. The contingency tables are reported in full in Annex 2.

136. We note that 39 of the 50 higher profitability FTSE 350 engagements identified in Appendix 14, Annex 4, are in the 519 companies identified in paragraph 134, and that 34 of these had not switched auditor in the last ten years.

137. We cannot identify those companies that held a tender and retained the incumbent firm.

138. We do not include changes from Arthur Andersen to Deloitte in the switching events (see paragraph 37). There were 11 changes from Arthur Andersen to other audit firms (not Deloitte) which are also not included. Including these 11 events would result in 339 (65 per cent) companies not switching audit firm during the ten-year period. Where relevant, this is discussed below. We also do not included instances where a company moved to/from a joint audit in the switching events.

139. Considering the status of companies at the beginning of the ten-year period: 84 per cent of FTSE 100, 68 per cent of FTSE 250, 62 per cent of other listed, and 60 per cent of private companies had not switched auditor in the last ten years. We also found that 82 per cent of companies that have been FTSE 350 for the entire ten-year period have not switched audit firm.

[18] The Pearson's chi-squared test compares the *observed* distribution of companies that have and have not switched across the company characteristic to what we would *expect* to observe if the company characteristic was independent of whether a company had switched audit firm or not.

140. We found no clear association between industry and the likelihood of a company having switched audit firm. We observed that all of the eight banks in the sample had not switched and a slightly lower proportion of Health Care companies had not switched compared with the total sample.

141. We divided companies into five equal groups based on the median total turnover (in March 2005 prices) of the company over the ten-year period. Among the largest 20 per cent of companies, a higher proportion of companies had not switched audit firm compared with smaller companies: 83 per cent compared with approximately 65 per cent across smaller companies. There were no differences among other sizes of company.

142. We used the number of countries requiring an audit and the number of partners on the UK audit team as measures of audit complexity. The engagement data provided information on the number of countries requiring an audit for 434 companies. We categorized the number of countries into: 1 country, 2–5, 6–20, 21–50 and 51 or more countries. Overall, we did not observe an association between the number of countries requiring an audit and whether a company has switched auditor. We did observe that 88 per cent of companies that required an audit in 51 or more countries did not switch audit firm (compared with between 64 and 73 per cent for companies requiring an audit in fewer countries).

143. We had information on the number of partners on the UK audit team for 454 companies. We note that while the number of partners only covers the UK audit team, this number could be indicative of the global complexity of the audit. We categorized the number of partners into: 1–2, 3–5, 6–10 and 11 or more partners. Unlike the number of countries using an audit, we found an association between the number of partners on the UK audit team and whether a company has switched in the last ten

years: 58 per cent of companies with only one or two partners on the audit team did not switch audit firm in the last ten years compared with 90 per cent of companies with 11 or more partners.

144. Using data provided by Dealogic on the annual total value of deals, we compared merger activity and whether companies had switched audit firm. The Dealogic data is only available for companies in the public data set that have been part of the FTSE 350 at some point during the period 2001 to 2011. As such, we consider merger activity only for those companies where data was available (430 companies[19]). A first approach split companies by whether they had conducted any merger activity at all: 71 per cent of companies that engaged in merger activity had not switched audit firm compared with 67 per cent of companies that had no merger activity.

145. A second approach categorized merger activity as the number of years in which there was deal activity: 0 years, 1–2, 3–5 and 6–10 years: 85 per cent of companies that had merger activity in 6–10 years did not switch audit firm. Approximately 67 per cent of companies with lower levels of activity or no activity did not switch audit firm. Overall the Pearson's chi-squared test suggested that the number of years of merger activity and whether a company has switched audit firm were not independent.[20]

146. We also considered the identity of the audit firm at the start of the period. The treatment of companies which were audited by Arthur Andersen is relevant here (see paragraph 138). Companies audited by Arthur Andersen are treated as having a 'Big 4' audit firm at the start of the period. A change of audit firm from Arthur Andersen to any other audit firm is not treated as a switch of audit firm.

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[19] The initial sample of 519 companies also includes companies that were part of the Top Track 100 at some point in the period 2006 to 2011, for which Dealogic data was not available. The 430 companies are companies that were part of the FTSE 350 index at some point during the period 2001 to 2011.

[20] It is also noted that the result of this test is dependent on the categorization of the number of years in which there was merger activity. A different categorization may not lead to the same conclusion.

147. We observed that 71 per cent of companies that had a Big 4 audit firm at the start of the ten-year period did not switch auditor, compared with 32 per cent of companies that had a non-Big-4 auditor. Within the Big 4 firms, companies that started the period with KPMG or Deloitte as their auditor were more likely not to switch audit firm (79 and 74 per cent respectively).[21]

Probit model of companies not switching audit firm

The model

148. We looked to identify the company characteristics that, all else equal, are associated with a higher or lower observed probability that a company has not switched audit firm during the last ten years.

149. An event 'not switched' (where a company has not switched audit firm in the last ten years) is assumed to occur when:

(i) $a + bX_i + \varepsilon_i > 0$

150. In expression (i), X_i is a vector of observable company characteristics and ε_i, representing unobservable factors, is assumed to follow a standard normal distribution. The coefficients in b will tell us the relative strengths of the influences measured in X. This model is equivalent to assuming that the probability of 'not switched' occurring, given the observed company characteristics in X, is a particular increasing function of the index a + bX, where a and b are coefficients to be estimated, and where the form of the function is determined by the standard normal distribution.

[21] We calculated that 78 per cent of companies with Arthur Andersen as auditor at the start of the period did not switch audit firm. The companies that did switch audit firm would have switched from the firm that took over the audit from Arthur Andersen. The 78 per cent of companies that did not switch audit firm is sensitive to the treatment of companies which changed from Arthur Andersen to an audit firm that was not Deloitte (see paragraph 138). Treating a change from Arthur Andersen to a firm that was not Deloitte (eg a change from Arthur Andersen to PwC) as a switch, we estimated that 66 per cent of companies with Arthur Andersen as auditor at the start of the period did not switch audit firm.

151. We estimated a cross-sectional model where the dependent variable was an indicator variable taking the value 1 if a company did not switch auditor during the ten-year period under consideration. Where a company changed from Arthur Andersen to Deloitte or another audit firm, we do not consider this to be a switch of audit firm.

152. The observed company characteristics considered for inclusion in X_i were:

(a) The industry a company was part of.

(b) Company 'life-cycle': indicators of whether a company has been private for ten years, FTSE 350 for ten years, a combination of other listed and FTSE 350 only for ten years, moved from private to listed during the period and moved from listed to private during the period.

(c) Company turnover: median value of turnover over ten-year period, in logarithms.

(d) Company risk: measured as the median value of current assets/current liabilities (total level of assets and liabilities for financial companies) over the ten-year period, in logarithms.

(e) The number of years in which a company made a loss: an indicator for companies which made a loss in at least six out of ten years.

(f) The complexity of the company audit: from the engagement data set we consider the median number of countries requiring an audit during 2006 to 2011 and the median number of partners on the UK audit during 2006 to 2011. We also considered the proportion of engagement hours accounted for by partners (see paragraph 154). If a company has switched auditor the median is taken across all company engagements. The number of countries was included as a categorical variable (as defined in paragraph 142). The number of partners is included in logarithms and the proportion of engagement hours accounted for by partners as a proportion. As noted above (see paragraph 143), the engagement data applies only to the UK part of the audit, but this should act as a good proxy for the complexity of the global audit. Also the engagement data set only covers the period

2006 to 2011, but the measures above should be indicative of the complexity of the company's audit between 2001 and 2011.

(g) Merger activity: we consider different options to capture the merger activity of a company—an indicator of whether a company engaged in merger activity or not and the number of years in which there was merger activity (both as a categorical variable (see paragraph 145) and in logarithms). As noted above (see paragraph 144), Dealogic data is available only for listed companies.

(h) Tenure: the length of the relationship with the audit firm at the beginning of the period, in logarithms.

(i) Auditor: identity of audit firm at the beginning of the period—we consider a split between non-Big-4 and Big 4 companies and non-Big-4 and the individual Big 4 companies. For the purposes of this variable we treat companies audited by Arthur Andersen at the beginning of the period as having a Big 4 audit firm.

(j) Industry experience: the number of engagements each audit firm had in each industry at the start of the period (see paragraphs 158 and 159).

153. We received a number of comments on the variables used in the analysis, which we consider below.

154. KPMG told us that the number of partners on the UK audit team should not be used as a measure of audit complexity. For example, the number of UK partners involved in the audit of two clients of equal size, where one has all its operations overseas and the other all of its operations in the UK (but otherwise identical), would be higher in the latter case. So a client with one or two UK partners involved may nevertheless be complex where scale and/or complexity is outside the UK. KPMG also told us that the number of partners may be a misleading indicator of the complexity of an audit given that the data captures all partners and staff that have charged hours to the engagement, regardless of how small a number of hours those partners and staff members

have spent on an engagement. Hence in this regard the data set might overestimate the number of partners with a substantial involvement in the audit, and could result in misleading conclusions.

155. Whilst we note KPMG's point we think that, all else equal, the number of partners on the UK audit team may be an indicator of complexity and that it is therefore informative to investigate any association between this variable and tenure. We included the median proportion of engagement hours accounted for by partners (between 2006 and 2011) as an alternative in one specification (see paragraph 170).

156. KPMG told us that measuring risk using the ratio of current assets to current liabilities was not sufficient as this was as an indication of a company's short-term liquidity and the risk of an audit was dependent on a number of factors, including industry, management capability, quality of systems and processes.

157. Deloitte proposed a number of characteristics that could be thought of as potential drivers of auditor switching that were identified in the CC survey. These were factors that the respondents to the CC survey identified as important in deciding whether to (re)appoint the auditor (such as experience and knowledge of engagement partner and engagement team, good working relationships with audit team, reputation of audit firm, sector-specific expertise or experience, expertise in audit-related services, adverse comment by regulator), reasons for not tendering (such as receiving high quality service, good value for money, happy as things are, partner rotation, switching costs, continuity/familiarity, time not right, incumbent understands business, benchmarking suggests get good value) and triggers of tenders (such as complacency of audit firm, substantial increase in audit fee, problematic relationship between auditor and management, pressure from shareholders, bankers, lawyers or

analysts, change in company ownership, nature or scale of activities, scandal in UK or another country related to current auditor).

158. Deloitte proposed that some of the factors identified could be accounted for in the model. Experience and knowledge of the engagement team and/or incumbent understands business could have been proxied through the number and/or asset base of clients audited by the audit firm in the same sector. Expertise in audit-related services could have been proxied through the non-audit-services fees provided—either historically, or to other auditor's clients. Substantial increases in audit fee could have been included in the model as a lagged change in the audit fee.

159. We included the number of audit engagements in each industry for each firm at the start of the period as an indicator of audit firm experience in some model specifications (see paragraph 176). We agree that the survey results indicate that a substantial increase in the audit fee is a potential trigger to switch auditor. However, we do not include the increase in audit fees as a variable in the model for the following reasons: it would be difficult to identify the extent of any fee increases not driven by substantial changes in the scope or complexity of the audit or audit-related work; we estimate a cross-sectional model which does not therefore take account of changes in company size over time; and there is a potential endogeneity problem including a measure of audit fee as a determinant of whether a company has switched audit firm (audit fees are likely to be determined by whether a company has switched audit firm). Due to the shorter time frame (2006 to 2011) of the engagement data set we could not meaningfully include a measure of non-audit-services provision in the model.

160. We recognize that unobservable aspects of audit complexity and quality are important factors that may not be sufficiently accounted for in the model. To the extent that

audit complexity is industry specific it will be captured by the industry dummy variables, although it is highly likely that there is still company specific complexity that is not accounted for. Some aspects of audit quality will be captured by the inclusion of dummy variables for the audit firm at the start of the period.

161. We have a reservations about the accuracy of the tenure variable (see paragraph 152*(h)*). As described above (see paragraph 69) a number of companies did not have data for the year of initial audit engagement and therefore the first year a company had data was taken as an estimate. This is likely to lead to an underestimate of the calculated tenure of the auditor. We calculated that in the sample of companies used for this analysis 27 per cent had missing tenure information. Among these companies 44 per cent had not switched auditor in the last ten years compared with 67 per cent of the total sample: depending on the true distribution of tenures among these companies this may distort the model estimates. This must be kept in mind in light of the results presented below.

Results

162. The probit model was estimated using data for the 519 companies that had ten years of data. In Tables 24, 25 and 26 we report results for our preferred model (Model 4). Table 24 provides a model summary. Table 25 reports the regression coefficients and the predicted probability that a company has not switched audit firm given company characteristics which are continuous (eg turnover, tenure). Table 26 reports the regression coefficients and the predicted probability that a company has not switched audit firm given company characteristics which are categorical (eg the auditor at the start of the ten-year period). We report results only for variables where the regression coefficient is statistically different from zero. Full regression output for this and other specifications is given in Annex 2.

163. Table 24 below provides a summary of the model. The regression estimates were based on 423 companies. Of these companies, we observed that 70 per cent had not switched audit firm during the ten-year period. Using the estimated coefficients ('a' and 'b' in paragraph 150), we estimated the probability that a company did not switch audit firm based on its observable characteristics. If this probability was greater than or equal to 0.5, we assumed that a company was predicted to have not switched audit firm. Of companies observed to have not switched audit firm, the model correctly predicted that a company did not switch audit firm in 90.9 per cent of cases. However, of companies observed to have switched audit firm, the model correctly predicted that a company switched in only 39.4 per cent of cases. This resulted in a combined correct prediction rate of 75.4 per cent. Given that we observed that 70 per cent of companies had not switched audit firm, using the observed characteristics of the companies improves the prediction accuracy by 5.4 per cent.[22]

164. It is therefore likely that a large proportion of the probability of whether a company has switched audit firm is driven by unobserved factors, for example the specific relationship a lead partner has with a company, whether there were years the company was unhappy with the audit it received and how this was handled.

TABLE 24 **Probit model summary**

Number	423
Proportion not switching (observed) (%)	70.0
Proportion not switching (correctly predicted) (%)	90.9
Proportion switching (correctly predicted) (%)	39.4
Proportion (combined) correctly predicted (%)	75.4

Source: CC.

165. As a result of the theoretical construct of the probit model, the effect of any company characteristic on the probability of a company not switching auditor varies depending on the assumed values of the company's characteristics. This, for example, is in

[22] Even if we knew nothing about the characteristics of a company, if we always predicted that a company did not switch audit firm we would be correct in 70 per cent of cases.

contrast to a traditional linear regression model, where the effect of a characteristic on the dependent variable is constant for all values of the characteristic.[23]

166. In Tables 25 and 26, we report the estimated regression coefficients. The value of a regression coefficient does not give the effect of a characteristic on the probability that a company did not switch audit firm (the calculation of the effect of a characteristic is described in the footnote to paragraph 165). The sign of the coefficient does, however, show the direction of the effect. For continuous characteristics, a positive (negative) coefficient indicates that an increase in the value of the characteristic has a positive (negative) effect on the probability that a company did not switch audit firm. For categorical variables, a positive (negative) coefficient indicates that the probability that a company with that characteristic did not switch audit firm is higher (lower) than the base category (the category which other categories are compared with). We report the statistical significance of the coefficients using asterisks. A coefficient followed by ** is interpreted as being 95 per cent confident that the coefficient is statistically different from zero.

167. Table 25 reports the estimated regression coefficients and the average predicted probabilities for continuous characteristics (assets, turnover, risk, tenure and the number of partners on the audit team). In assessing the effect of a particular company characteristic, our approach is to estimate the average predicted probability (across companies) that a company did not switch audit firm for a given value of the characteristic. For each continuous characteristic, we report the difference in predicted probability for a representative 'large' company (the 75th percentile value for

[23] Consider that a regression model $y = a + b_1X_1 + b_2X_2 + \varepsilon$ and X_1 and X_2 represent two different company characteristics. In a linear regression model, the effect of a one-unit change in characteristic X_2 on y is b_2 for all values of X_2. In a probit model, the effect of a one-unit change in X_2 on y is dependent on $a + b_1\overline{X}_1 + b_2\overline{X}_2$ as well as b_2, therefore the effect of a change in X_2 on y depends on the value of X_2 and also the value of the other characteristic X_1. The values $\overline{X}_1$ and $\overline{X}_2$ are the values we choose for characteristics X_1 and X_2 at which to evaluate the effect of X_2 on y.

the characteristic) versus a representative 'small' company (the 25th percentile value for the characteristic).[24]

TABLE 25 **Probit model continuous variable regression coefficients and predicted probabilities of not switching**

		Average predicted probability		
Continuous characteristic	*Coefficient*	*25th percentile %*	*75th percentile %*	*Difference %*
Assets	–0.12	72.5	66.7	–5.8
Turnover	0.27***	61.5	76.7	15.2
Risk	0.32***	65.2	70.8	5.6
Tenure	0.35***	59.9	79.4	19.6
Number of partners	0.21	67.8	73.0	5.2

Source: CC.

* 90%, ** 95%, *** 99%.

168. Table 25 tells us that the predicted probability of a company not switching audit firm is 76.7 per cent for companies with a turnover value equal to the 75th percentile (larger than 75 per cent of other companies) and 61.5 per cent for companies with a turnover value equal to the 25th percentile (smaller than 75 per cent of other companies), averaging across the other observed characteristics of companies. The increased predicted probability for larger companies is reflective of the significant positive coefficient (0.27) and the higher observed proportion of companies not switching audit firm among the largest 20 per cent of companies (see paragraph 141).

169. We observe a large difference for the tenure of the audit firm at the start of the ten-year period, but given our reservations about the calculation of tenure (see paragraph 161) we are cautious of drawing conclusions from this observation.

[24] Continuing the example of the previous footnote, assume that X_1 represents turnover and X_2 represents risk and these are the only two observed company characteristics. To calculate the predicted probability that a company with a turnover value equal to the 75th percentile did not switch audit firm, we set $\overline{X}_1$ equal to the 75th percentile for turnover for all companies and set $\overline{X}_2$ equal to each company's value for risk. This allows us to calculate a predicted probability of not switching for each company. The average of each company predicted probability is then calculated and reported.

170. The characteristic 'number of partners' aims to capture the complexity of the audit, but there is no significant effect of this characteristic on the probability that a company did not switch audit firm on top of other company characteristics. In model 5 (see Annex 2) we consider the proportion of engagement hours accounted for by partners (see paragraphs 154 and 155), but there was also no significant effect on the probability that a company did not switch audit firm.

171. Table 26 reports the estimated regression coefficients and the average predicted probabilities for categorical characteristics (audit firm at beginning of period, index designation movement of company and number of years of merger activity). As in Table 25, we report the estimated average predicted probability (across companies) that a company did not switch audit firm for a given characteristic. For each category, the average predicted probability is the probability that a company with that characteristic (eg had PwC as audit firm at the start of the period) did not switch audit firm during the period, averaging across the other observed characteristics of companies.

TABLE 26 **Probit model categorical variable regression coefficients and predicted probabilities of not switching**

Categorical variable	*Coefficient*	*Average predicted probability %*
Non-Big-4 at start of period (base)	0	47.1
Big 4 (and AA) firm dummy variables		
[✂]	0.62**	67.6
[✂]	0.86***	74.8
[✂]	1.06***	80.0
[✂]	0.7**	70.2
[✂]	1.41***	87.2
Company loss in fewer than 6 years	0	69.5
Company loss in 6 or more years	0.32	77.8
Private for ten years (base)	0	62.2
FTSE 350 for ten years	0.39	73.5
FTSE 350 and Other listed	0.28	70.6
Moved from listed to private	–0.33	51.6
Moved from private to listed	0.74**	82.0
No merger activity (base)	0	75.1
Activity in 1–2 years	–0.28	67.6
Activity in 3–5 years	–0.56**	59.3
Activity in 6–10 years	–0.18	70.4

Source: CC.

* 90%, ** 95%, *** 99%.

172. Table 26 tells us that the predicted probability that a company with a non-Big-4 audit firm at the start of the period did not switch audit firm is 47.1 per cent. This is significantly lower than the predicted probabilities for other Big 4 (and Arthur Andersen) firms, with a minimum predicted probability of 68 per cent for [✂]. This is reflective of the significant positive coefficients for the Big 4 firms and the observed differences in proportions of companies not switching audit firm for different initial audit firms (see paragraph 147).

173. It can be inferred from Table 26 that [✂] had the highest 'retention rate' of clients during the ten-year period.[25] The predicted probability that a company which had [✂] as auditor did not switch audit firm is 80 per cent, more than 12 per cent higher than [✂] and nearly 10 per cent higher than [✂]. [✂]'s probability could be viewed as actually being [✂].

174. Table 26 shows a slightly significant positive effect for companies which moved from private to listed status during the ten-year period: the predicted probability of a company that moved from private to listed and did not switch audit firm is 82.0 per cent (higher than companies that were in the FTSE 350 for ten years (73.5 per cent)).[26]

175. There does not appear to be a systematic effect on the level of merger activity and the predicted probability that a company did not switch audit firm. The predicted probabilities for companies that engaged in merger activity are lower than for companies that engaged in no merger activity, but only the coefficient on merger activity in three to five years is statistically different from zero at any level.[27]

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[25] [✂]
[26] This model does not capture the effect of moving from other listed to FTSE 350 status. This was discussed in the previous section.
[27] The timing of observed switching of audit firm and merger activity is explored further in the working paper 'The life cycle of FTSE 350 companies' (to be published).

176. In models 6 and 7 (see Annex 3) we include the number of industry clients at the beginning of the period to account for audit firm experience (see paragraphs 158 and 159). We found no significant effect of this variable on the probability that a company did not switch audit firm, and no material changes to the coefficients for other variables compared with other specifications.

Underlying statistics

1. In this annex, we report the raw statistics underlying the figures in the main text and additional statistics that are not reported above. We report:

   (a) Table 1 to Table 40: firm shares of audit enagagements and audit fees by index designations, industry (among FTSE 350 companies) and company turnover.

   (b) Table 41 to Table 44: statistics on reported company audit fees and annual changes in audit fee by index designation and the median audit fee within each industry (for FTSE 350 companies).

   (c) Table 45 to Table 46: switching rates by index designation and by industry (for FTSE 350 companies).

   (d) Table 47: Tenure of current auditors by index designation.

   (e) Table 48: Ratio of non-audit service to audit-related fees by index designation.

   (f) Table 49 to Table 52: Proportions of engagement hours and staff costs accounted for by each grade of staff by index designations, years and audit firm.

   (g) Table 53 and Table 54: Fee per hour by index designation and audit firm.

   (h) Table 55 and Table 56: Changes in fee per hour and composition of engagement team before and after a switch by index designation.

   (i) Table 57: Audit firm revenue recovery rates.

   (j) Table 58: Audit firm grade scale rates 2011.

TABLE 1 **Market shares of audit engagements, all companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	31.7	32.6	33.2	32.2	31.1	30.4	29.7	29.8	30.4	29.5
Deloitte	13.5	19.4	20.5	21.0	21.8	21.9	22.4	22.9	23.3	23.1
KPMG	23.6	23.1	22.9	23.5	23.7	23.3	23.0	22.4	22.5	23.6
EY	13.8	15.2	14.3	14.9	15.2	16.0	16.2	16.3	15.7	15.2
BDO	2.3	2.1	2.2	2.4	2.7	2.5	2.2	2.3	2.2	2.6
GT	2.6	2.4	2.1	1.9	1.8	1.9	2.8	3.2	3.2	3.4
Arthur Andersen	7.8	0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	4.7	4.8	4.6	4.0	3.8	4.0	3.7	3.2	2.8	2.7
Big 4	90.5	90.8	91.1	91.7	91.7	91.6	91.2	91.3	91.8	91.3

Source: CC.

TABLE 2 **Market shares of audit fees, all companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	43.9	41.6	42.4	40.5	39.1	43.0	39.5	39.7	41.0	39.4
Deloitte	12.0	17.3	16.0	17.5	19.0	17.7	18.7	20.8	20.9	18.7
KPMG	23.5	22.5	23.5	24.2	24.3	22.8	25.8	24.2	21.9	23.7
EY	11.9	16.4	15.8	15.9	16.3	15.3	14.7	13.9	15.0	17.0
BDO	0.6	0.6	0.5	0.5	0.7	0.6	0.6	0.6	0.5	0.5
GT	0.4	0.4	0.3	0.3	0.3	0.3	0.4	0.5	0.5	0.5
Arthur Andersen	6.7	0.3	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	1.0	0.9	0.8	1.0	0.3	0.3	0.3	0.4	0.2	0.2
Big 4	98.1	98.1	98.4	98.2	98.7	98.8	98.7	98.6	98.8	98.8

Source: CC.

TABLE 3 **Market shares of audit engagements, FTSE 350 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	37.5	36.7	37.4	36.4	36.1	34.6	33.2	32.6	31.0	31.5
Deloitte	13.7	21.0	20.5	21.9	23.6	23.8	25.7	25.5	26.1	25.4
KPMG	25.0	24.0	24.0	22.4	21.5	21.7	22.2	20.8	22.0	22.7
EY	12.8	14.8	15.4	16.6	16.7	17.0	16.0	17.0	17.1	17.2
BDO	0.9	0.9	0.6	0.6	1.2	1.8	1.5	2.1	2.0	1.5
GT	0.9	0.9	0.6	0.9	0.6	0.9	1.5	1.8	1.4	1.7
Arthur Andersen	7.7	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	1.5	1.5	1.5	1.2	0.3	0.3	0.0	0.3	0.3	0.0
Big 4	96.7	96.7	97.3	97.4	97.9	97.1	97.1	95.9	96.2	96.8

Source: CC.

TABLE 4 **Market shares of audit fees, FTSE 350 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	45.5	43.3	43.8	41.8	41.3	45.3	41.1	41.4	41.9	41.0
Deloitte	12.4	15.4	15.2	16.9	17.6	16.7	18.3	21.0	21.5	18.5
KPMG	23.2	23.5	24.0	23.6	23.7	23.0	26.6	24.5	22.5	23.8
EY	11.4	16.9	16.6	16.8	17.2	14.7	13.5	12.6	13.7	16.3
BDO	0.2	0.3	0.0	0.1	0.2	0.2	0.3	0.4	0.3	0.2
GT	0.1	0.2	0.1	0.1	0.0	0.0	0.2	0.2	0.2	0.2
Arthur Andersen	6.8	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.4	0.2	0.3	0.8	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	99.3	99.4	99.6	99.1	99.8	99.8	99.6	99.4	99.5	99.6

Source: CC.

TABLE 5 **Market shares of audit engagements, FTSE 100 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	45.8	42.9	48.0	43.3	42.6	41.2	39.4	39.8	37.4	38.0
Deloitte	13.5	20.4	17.3	20.6	20.2	18.6	23.2	21.4	22.2	21.0
KPMG	25.0	23.5	22.4	21.6	20.2	22.7	22.2	24.5	24.2	22.0
EY	11.5	13.3	12.2	14.4	16.0	16.5	15.2	14.3	15.2	18.0
BDO	0.0	0.0	0.0	0.0	1.1	1.0	0.0	0.0	1.0	1.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	4.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	98.9	99.0	100.0	100.0	99.0	99.0

Source: CC.

TABLE 6 **Market shares of audit fees, FTSE 100 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	50.1	45.7	45.2	44.0	42.4	49.3	43.9	44.1	44.2	43.9
Deloitte	9.6	13.9	14.2	15.8	15.7	13.8	15.5	17.6	18.2	15.3
KPMG	22.1	22.9	25.3	24.6	24.6	23.2	27.8	26.3	24.1	24.5
EY	12.1	17.5	15.3	15.6	17.3	13.6	12.9	12.0	13.3	16.2
BDO	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.1	0.1
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	99.9	99.9	100.0	100.0	99.9	99.9

Source: CC.

TABLE 7 **Market shares of audit engagements, FTSE 250 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	34.2	34.2	33.1	33.7	33.6	32.0	30.7	29.6	28.5	28.8
Deloitte	13.8	21.3	21.8	22.4	24.9	25.8	26.6	27.2	27.6	27.2
KPMG	25.0	24.2	24.7	22.8	22.0	21.3	22.1	19.3	21.1	23.0
EY	13.3	15.4	16.7	17.5	17.0	17.2	16.4	18.1	17.9	16.9
BDO	1.3	1.3	0.8	0.8	1.2	2.0	2.0	2.9	2.4	1.6
GT	1.3	1.3	0.8	1.2	0.8	1.2	2.0	2.5	2.0	2.5
Arthur Andersen	9.2	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	2.1	2.1	2.1	1.6	0.4	0.4	0.0	0.4	0.4	0.0
Big 4	95.4	95.4	96.2	96.3	97.5	96.3	95.9	94.2	95.1	95.9

Source: CC.

TABLE 8 **Market shares of audit fees, FTSE 250 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	32.7	35.9	39.8	36.0	38.4	32.7	32.4	32.7	33.3	30.2
Deloitte	20.2	20.2	17.9	19.7	22.8	26.0	27.4	31.7	33.6	30.4
KPMG	26.4	25.4	20.5	21.0	21.3	22.3	22.7	18.6	16.2	21.2
EY	9.3	14.9	20.2	19.8	16.9	18.4	15.5	14.6	15.1	16.5
BDO	0.9	1.1	0.2	0.3	0.5	0.6	1.2	1.5	1.1	0.7
GT	0.5	0.7	0.3	0.3	0.1	0.1	0.7	0.9	0.7	0.8
Arthur Andersen	8.6	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	1.4	0.9	1.2	2.9	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	97.2	97.3	98.4	96.5	99.5	99.3	98.1	97.6	98.2	98.4

Source: CC.

TABLE 9 **Market shares of audit engagements, non-FTSE-350 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	25.8	28.5	29.1	27.9	26.0	26.2	26.0	26.7	29.6	27.0
Deloitte	13.4	17.7	20.6	20.1	19.9	20.0	19.0	19.9	19.9	20.3
KPMG	22.2	22.2	21.8	24.6	26.0	25.0	23.9	24.1	23.0	24.6
EY	14.9	15.6	13.2	13.2	13.6	15.0	16.3	15.4	13.9	12.8
BDO	3.6	3.3	3.8	4.2	4.2	3.2	3.0	2.6	2.4	3.9
GT	4.3	3.9	3.5	3.0	3.0	2.9	4.2	4.8	5.2	5.3
Arthur Andersen	7.9	0.6	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	7.9	8.1	7.6	6.9	7.3	7.6	7.6	6.4	5.9	6.0
Big 4	84.2	84.7	85.0	85.9	85.5	86.2	85.2	86.2	86.4	84.7

Source: CC.

TABLE 10 **Market shares of audit fees, non-FTSE-350 companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	35.3	33.3	35.7	33.4	27.3	30.4	30.4	29.7	36.1	29.0
Deloitte	9.9	26.3	20.1	21.0	26.4	22.8	20.4	19.6	17.7	20.2
KPMG	25.3	17.5	20.7	27.9	27.7	22.1	21.5	22.3	18.5	22.8
EY	14.9	14.2	12.1	10.9	11.1	18.2	21.4	21.8	22.4	21.9
BDO	2.5	2.2	2.7	3.1	3.3	2.6	2.3	1.8	1.2	2.1
GT	1.6	1.4	1.6	1.5	2.0	1.9	2.0	2.3	2.7	2.6
Arthur Andersen	6.2	0.9	3.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	4.3	4.3	3.3	2.3	2.1	1.9	2.0	2.5	1.4	1.5
Big 4	91.6	92.2	92.4	93.1	92.6	93.5	93.7	93.5	94.7	93.9

Source: CC.

TABLE 11 **Market shares of audit engagements, FTSE 350 Basic Materials companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	50.0	57.1	50.0	57.1	42.9	40.0	28.6	25.0	33.3	22.2
Deloitte	0.0	14.3	12.5	14.3	14.3	0.0	14.3	12.5	16.7	33.3
KPMG	33.3	28.6	37.5	28.6	42.9	60.0	42.9	37.5	33.3	33.3
EY	0.0	0.0	0.0	0.0	0.0	0.0	14.3	25.0	16.7	11.1
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	16.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 12 **Market shares of audit fees, FTSE 350 Basic Materials companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	52.4	56.2	62.0	61.2	59.3	43.8	7.3	9.1	12.3	10.6
Deloitte	0.0	3.9	2.7	2.8	3.9	0.0	32.2	50.1	54.0	55.9
KPMG	40.5	39.9	35.3	36.0	36.8	56.2	54.6	26.6	23.3	25.1
EY	0.0	0.0	0.0	0.0	0.0	0.0	5.9	14.2	10.4	8.4
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	7.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 13 **Market shares of audit engagements, FTSE 350 Banks companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	27.3	27.3	27.3	27.3	30.0	33.3	33.3	25.0	40.0	40.0
Deloitte	27.3	27.3	27.3	27.3	20.0	22.2	22.2	25.0	20.0	20.0
KPMG	45.5	45.5	45.5	45.5	50.0	44.4	44.4	50.0	40.0	40.0
EY	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 14 **Market shares of audit fees, FTSE 350 Banks companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	47.7	36.8	29.3	31.6	35.1	49.1	43.8	37.5	42.9	47.3
Deloitte	14.9	18.8	19.9	19.9	16.6	10.6	14.4	24.6	25.0	19.7
KPMG	37.3	44.4	50.8	48.5	48.3	40.3	41.8	37.8	32.0	33.0
EY	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 15 **Market shares of audit engagements, FTSE 350 Consumer Goods companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	44.8	45.2	41.2	41.7	47.1	44.1	44.4	47.8	42.9	53.8
Deloitte	10.3	19.4	14.7	13.9	14.7	14.7	14.8	17.4	17.9	11.5
KPMG	27.6	25.8	29.4	27.8	23.5	23.5	29.6	26.1	28.6	26.9
EY	10.3	9.7	11.8	13.9	14.7	17.6	11.1	8.7	10.7	7.7
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	6.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	2.9	2.8	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	97.1	97.2	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 16 **Market shares of audit fees, FTSE 350 Consumer Goods companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	68.9	66.6	62.8	65.7	67.3	71.7	67.3	72.0	68.7	76.5
Deloitte	4.3	9.2	8.5	9.5	11.4	10.1	13.5	9.9	11.8	1.9
KPMG	18.0	21.8	23.8	20.6	17.0	14.6	17.9	17.3	18.4	20.8
EY	2.6	2.3	4.6	3.9	4.3	3.6	1.4	0.8	1.1	0.8
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	6.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.3	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	99.7	99.7	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 17 **Market shares of audit engagements, FTSE 350 Consumer Services companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	37.2	37.5	37.8	35.4	34.8	38.6	36.4	33.3	31.7	29.7
Deloitte	15.4	22.5	24.4	25.3	29.0	25.7	27.3	27.0	27.0	26.6
KPMG	21.8	20.0	19.5	19.0	13.0	12.9	13.6	11.1	14.3	18.8
EY	14.1	17.5	18.3	19.0	20.3	18.6	18.2	22.2	20.6	20.3
BDO	1.3	1.3	0.0	1.3	2.9	4.3	3.0	4.8	4.8	1.6
GT	1.3	0.0	0.0	0.0	0.0	0.0	1.5	1.6	1.6	3.1
Arthur Andersen	9.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	97.4	98.8	100.0	98.7	97.1	95.7	95.5	93.7	93.7	95.3

Source: CC.

TABLE 18 **Market shares of audit fees, FTSE 350 Consumer Services companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	37.1	37.9	43.4	39.2	33.0	35.1	37.5	30.2	31.6	28.8
Deloitte	16.8	31.0	33.0	37.4	40.4	41.1	43.3	47.6	48.2	47.3
KPMG	11.7	15.1	9.9	8.7	6.4	8.1	6.1	6.5	7.7	10.0
EY	10.1	14.0	13.7	14.4	19.3	14.8	11.2	13.3	10.5	12.4
BDO	0.2	0.3	0.0	0.4	0.8	1.0	1.1	1.4	1.2	0.5
GT	0.1	0.0	0.0	0.0	0.0	0.0	0.8	0.9	0.7	1.2
Arthur Andersen	24.0	1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	99.6	99.7	100.0	99.6	99.2	99.0	98.1	97.7	98.1	98.3

Source: CC.

TABLE 19 **Market shares of audit engagements, FTSE 350 Financial services companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	39.3	35.5	36.1	35.9	34.8	31.8	31.0	34.2	32.1	32.0
Deloitte	11.5	14.5	18.0	17.2	16.7	21.2	25.4	21.9	25.6	25.3
KPMG	18.0	19.4	18.0	14.1	16.7	13.6	14.1	13.7	16.7	16.0
EY	21.3	24.2	23.0	28.1	27.3	27.3	25.4	24.7	20.5	21.3
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	1.3	1.3
GT	1.6	1.6	1.6	3.1	3.0	4.5	4.2	4.1	2.6	4.0
Arthur Andersen	3.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	4.9	4.8	3.3	1.6	1.5	1.5	0.0	0.0	1.3	0.0
Big 4	93.4	93.5	95.1	95.3	95.5	93.9	95.8	94.5	94.9	94.7

Source: CC.

TABLE 20 **Market shares of audit fees, FTSE 350 Financial services companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	48.7	39.4	38.8	34.9	40.5	55.7	43.5	44.8	37.1	40.9
Deloitte	17.8	18.9	27.6	26.1	16.9	15.8	24.3	22.1	25.7	18.0
KPMG	15.8	11.5	8.5	6.3	8.8	5.1	6.6	6.7	9.2	8.6
EY	10.8	29.8	24.9	32.1	33.2	22.9	25.0	25.5	27.6	32.0
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.3	0.3
GT	0.2	0.1	0.1	0.5	0.4	0.4	0.6	0.6	0.1	0.2
Arthur Andersen	6.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.4	0.3	0.2	0.1	0.1	0.0	0.0	0.0	0.1	0.0
Big 4	99.4	99.6	99.7	99.5	99.5	99.5	99.4	99.1	99.5	99.4

Source: CC.

TABLE 21 **Market shares of audit engagements, FTSE 350 Health Care companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	46.2	46.2	50.0	57.1	28.6	37.5	28.6	14.3	10.0	12.5
Deloitte	0.0	15.4	10.0	14.3	28.6	25.0	28.6	42.9	40.0	37.5
KPMG	23.1	23.1	30.0	14.3	28.6	25.0	28.6	28.6	40.0	37.5
EY	15.4	15.4	10.0	14.3	14.3	12.5	14.3	14.3	10.0	12.5
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	15.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 22 **Market shares of audit fees, FTSE 350 Health Care companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	66.0	66.2	60.4	55.2	54.0	51.2	50.1	50.9	54.2	54.1
Deloitte	0.0	4.0	8.0	13.6	8.1	5.6	7.3	9.3	10.8	9.7
KPMG	23.9	23.1	24.9	23.4	29.0	31.8	33.6	29.8	28.1	29.8
EY	6.1	6.7	6.7	7.8	8.9	11.5	9.0	10.0	6.9	6.4
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	4.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 23 **Market shares of audit engagements, FTSE 350 Industrials companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	33.8	29.7	35.3	34.3	34.3	27.1	29.7	32.4	27.5	27.9
Deloitte	21.1	28.4	26.5	27.1	29.9	31.4	31.1	32.4	34.8	31.1
KPMG	26.8	29.7	26.5	28.6	29.9	34.3	33.8	31.0	30.4	34.4
EY	7.0	8.1	8.8	8.6	6.0	5.7	4.1	2.8	5.8	4.9
BDO	1.4	1.4	1.5	0.0	0.0	1.4	1.4	1.4	1.4	1.6
GT	1.4	1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	5.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	2.8	1.4	1.5	1.4	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	94.4	95.9	97.1	98.6	100.0	98.6	98.6	98.6	98.6	98.4

Source: CC.

TABLE 24 **Market shares of audit fees, FTSE 350 Industrials companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	39.7	33.2	39.3	34.6	39.5	30.5	34.5	31.8	31.1	30.0
Deloitte	13.6	20.5	16.9	15.9	18.2	22.8	21.3	25.6	24.9	20.2
KPMG	27.3	32.3	28.1	28.6	32.6	37.9	39.6	40.1	39.2	45.1
EY	8.7	11.1	14.8	16.6	9.6	8.4	4.3	2.1	4.4	4.4
BDO	1.2	1.3	0.1	0.0	0.0	0.3	0.3	0.4	0.3	0.3
GT	0.7	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	6.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	2.2	0.9	0.9	4.2	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	95.9	97.0	99.0	95.8	100.0	99.7	99.7	99.6	99.7	99.7

Source: CC.

TABLE 25 **Market shares of audit engagements, FTSE 350 Insurance companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	44.4	33.3	35.7	33.3	33.3	41.2	31.3	26.7	37.5	35.3
Deloitte	0.0	8.3	7.1	13.3	6.7	5.9	12.5	13.3	6.3	11.8
KPMG	44.4	41.7	42.9	40.0	46.7	35.3	37.5	40.0	25.0	23.5
EY	11.1	8.3	7.1	6.7	13.3	17.6	18.8	20.0	31.3	29.4
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	8.3	7.1	6.7	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	91.7	92.9	93.3	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 26 **Market shares of audit fees, FTSE 350 Insurance companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	28.9	27.5	20.6	18.0	17.1	34.1	12.6	18.7	18.8	14.4
Deloitte	0.0	1.4	0.8	3.2	0.8	0.7	5.1	7.6	6.0	6.6
KPMG	48.4	38.5	40.1	42.5	47.8	38.1	55.5	44.8	33.1	31.5
EY	22.7	31.3	36.9	34.5	34.3	27.1	26.8	28.9	42.2	47.5
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	1.3	1.7	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	98.7	98.3	98.2	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 27 **Market shares of audit engagements, FTSE 350 Mining companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	20.0	16.7	16.7	14.3	14.3	11.1	16.7	18.8	13.3	18.8
Deloitte	40.0	33.3	33.3	42.9	42.9	33.3	25.0	25.0	26.7	31.3
KPMG	40.0	33.3	33.3	28.6	28.6	22.2	16.7	12.5	13.3	12.5
EY	0.0	16.7	16.7	14.3	14.3	33.3	33.3	37.5	40.0	31.3
BDO	0.0	0.0	0.0	0.0	0.0	0.0	8.3	6.3	6.7	6.3
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	91.7	93.8	93.3	93.8

Source: CC.

TABLE 28 **Market shares of audit fees, FTSE 350 Mining companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	25.5	21.6	19.9	22.0	24.0	20.3	37.4	35.8	33.0	27.1
Deloitte	48.2	51.2	40.1	37.4	41.4	35.1	19.6	14.6	17.8	19.6
KPMG	26.3	20.7	27.1	27.9	25.5	25.2	24.0	27.0	24.9	27.7
EY	0.0	6.5	12.9	12.6	9.1	19.3	18.2	21.8	23.1	24.8
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.7	1.2	0.8
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	99.2	99.3	98.8	99.2

Source: CC.

TABLE 29 **Market shares of audit engagements, FTSE 350 Oil & Gas companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	25.0	40.0	40.0	36.4	33.3	41.2	36.8	28.6	31.6	33.3
Deloitte	0.0	20.0	10.0	27.3	33.3	29.4	31.6	28.6	26.3	28.6
KPMG	25.0	10.0	10.0	9.1	6.7	5.9	5.3	14.3	15.8	9.5
EY	25.0	30.0	40.0	27.3	26.7	23.5	21.1	19.0	21.1	28.6
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	5.3	4.8	5.3	0.0
Arthur Andersen	25.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	4.8	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	94.7	90.5	94.7	100.0

Source: CC.

TABLE 30 **Market shares of audit fees, FTSE 350 Oil & Gas companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	40.9	36.3	53.8	53.4	40.8	50.3	46.3	49.1	55.0	52.6
Deloitte	0.0	0.7	0.4	1.0	2.0	2.4	3.0	2.3	2.5	3.9
KPMG	5.9	3.1	5.2	4.9	4.1	1.8	2.0	2.7	2.4	0.5
EY	52.2	60.0	40.6	40.7	53.1	45.5	48.3	45.5	39.6	43.0
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.4	0.4	0.0
Arthur Andersen	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	99.6	99.6	99.6	100.0

Source: CC.

TABLE 31 **Market shares of audit engagements, FTSE 350 real estate companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	20.0	25.0	25.0	40.0	40.0	33.3	20.0	14.3	16.7	25.0
Deloitte	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
KPMG	60.0	50.0	50.0	40.0	20.0	33.3	60.0	42.9	33.3	37.5
EY	0.0	0.0	0.0	0.0	0.0	0.0	0.0	14.3	16.7	12.5
BDO	20.0	25.0	25.0	20.0	40.0	33.3	20.0	14.3	16.7	12.5
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	14.3	16.7	12.5
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	80.0	75.0	75.0	80.0	60.0	66.7	80.0	71.4	66.7	75.0

Source: CC.

TABLE 32 **Market shares of audit fees, FTSE 350 real estate companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	38.7	41.4	38.9	28.1	68.0	64.1	50.5	35.6	48.4	34.9
Deloitte	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
KPMG	54.3	48.3	51.3	68.6	10.5	15.9	31.8	27.4	20.6	36.0
EY	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.7	2.2	2.2
BDO	7.0	10.3	9.7	3.3	21.5	20.1	17.7	21.9	15.6	15.2
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	13.3	13.2	11.8
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	93.0	89.7	90.3	96.7	78.5	79.9	82.3	64.7	71.2	73.0

Source: CC.

TABLE 33 **Market shares of audit engagements, FTSE 350 Technology companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	27.8	40.0	33.3	33.3	33.3	33.3	38.5	46.2	37.5	35.3
Deloitte	16.7	20.0	25.0	25.0	33.3	25.0	23.1	23.1	18.8	17.6
KPMG	11.1	0.0	0.0	0.0	0.0	8.3	0.0	0.0	18.8	17.6
EY	22.2	30.0	33.3	33.3	33.3	33.3	38.5	30.8	25.0	29.4
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	10.0	8.3	8.3	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	22.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	90.0	91.7	91.7	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 34 **Market shares of audit fees, FTSE 350 Technology companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	16.2	24.4	19.7	23.2	32.1	42.0	44.0	56.4	46.7	43.7
Deloitte	35.1	12.1	12.3	20.3	26.3	15.9	21.2	17.3	24.5	23.7
KPMG	2.0	0.0	0.0	0.0	0.0	0.4	0.0	0.0	4.3	3.1
EY	41.1	62.8	65.8	54.6	41.6	41.7	34.8	26.3	24.5	29.5
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.7	2.3	1.9	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	5.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	99.3	97.7	98.1	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 35 **Market shares of audit engagements, FTSE 350 Telecommunications companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	28.6	33.3	33.3	28.6	50.0	33.3	33.3	33.3	40.0	28.6
Deloitte	14.3	50.0	33.3	42.9	37.5	50.0	50.0	50.0	40.0	42.9
KPMG	28.6	16.7	33.3	28.6	12.5	16.7	16.7	16.7	20.0	28.6
EY	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	28.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 36 **Market shares of audit fees, FTSE 350 Telecommunications companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	45.8	45.2	54.0	43.3	51.2	43.0	43.9	43.1	44.4	41.7
Deloitte	18.1	24.1	18.8	27.1	24.6	39.9	39.6	38.8	44.7	42.0
KPMG	32.5	30.7	27.2	29.6	24.2	17.1	16.6	18.1	10.9	16.3
EY	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 37 **Market shares of audit engagements, FTSE 350 Utilities companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	60.0	58.3	54.5	50.0	46.2	41.7	45.5	40.0	33.3	33.3
Deloitte	0.0	8.3	9.1	8.3	15.4	25.0	27.3	30.0	33.3	33.3
KPMG	26.7	16.7	18.2	16.7	15.4	16.7	18.2	20.0	22.2	22.2
EY	13.3	16.7	18.2	25.0	23.1	16.7	9.1	10.0	11.1	11.1
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 38 **Market shares of audit fees, FTSE 350 Utilities companies**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	80.1	87.5	83.3	80.7	75.5	61.1	73.0	72.0	73.8	72.1
Deloitte	0.0	2.7	3.7	3.1	10.4	18.5	11.0	9.2	8.7	8.0
KPMG	16.5	6.0	9.3	11.5	10.2	17.2	14.6	17.7	16.3	18.6
EY	3.4	3.8	3.7	4.7	3.9	3.2	1.4	1.1	1.2	1.3
BDO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arthur Andersen	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Big 4	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CC.

TABLE 39 **Market shares of audit engagements by turnover, FTSE 350 companies 2010**

per cent

	1st (smallest)	*2nd*	*3rd*	*4th*	*5th (largest)*
PwC	23.5	25.0	33.8	30.9	44.1
Deloitte	19.1	33.8	23.5	25.0	25.0
KPMG	26.5	22.1	23.5	17.6	25.0
EY	20.6	16.2	19.1	23.5	5.9
BDO	4.4	2.9	0.0	0.0	0.0
GT	5.9	0.0	0.0	2.9	0.0
Other	0.0	0.0	0.0	0.0	0.0
Big 4	89.7	97.1	100.0	97.1	100.0

Source: CC.

TABLE 40 **Market shares of audit fees by turnover, FTSE 350 companies 2010**

per cent

	1st (smallest)	*2nd*	*3rd*	*4th*	*5th (largest)*
PwC	19.2	26.6	34.4	28.8	46.2
Deloitte	35.7	35.9	21.9	13.6	18.1
KPMG	25.1	16.9	25.0	29.4	22.8
EY	9.8	18.0	18.7	27.4	12.8
BDO	7.5	2.5	0.0	0.0	0.0
GT	2.7	0.0	0.0	0.8	0.0
Other	0.0	0.0	0.0	0.0	0.0
Big 4	89.8	97.5	100.0	99.2	100.0

Source: CC.

TABLE 41 **Summary statistics of real audit fees and changes in real audit fees, FTSE 100 companies, 2001 to 2010**

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
										£'000
Real audit fee										
Median	2,110	2,083	2,057	2,648	2,772	3,455	2,800	2,695	2,722	2,825
Mean	3,451	3,675	3,692	4,301	5,073	5,570	5,332	5,623	5,853	5,563
Min	154	144	34	165	193	211	6	140	160	145
Max	24,120	33,903	28,775	33,108	41,931	40,385	36,723	39,269	41,215	44,521
										per cent
Real audit fee change										
Median		8	4	18	14	8	–2	7	4	–3
Mean		18	15	24	21	19	2	10	7	–3
10th percentile		–24	–35	–3	–9	–24	–35	–24	–19	–26
90th percentile		60	62	67	64	67	40	34	40	14

Source: CC.

TABLE 42 **Summary statistics of real audit fees and changes in real audit fees, FTSE 250 companies, 2001 to 2010**

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
										£'000
Real audit fee										
Median	317	333	315	339	412	385	444	500	355	342
Mean	544	527	558	635	727	694	701	814	625	603
Min	9	9	8	10	10	13	17	16	16	14
Max	6,322	3,946	8,214	7,049	5,908	5,155	5,305	5,388	6,514	9,846
										per cent
Real audit fee change										
Median		5	6	5	13	1	4	4	–3	–4
Mean		17	15	13	25	9	13	15	3	1
10th percentile		–8	–21	–13	–6	–26	–21	–13	–27	–23
90th percentile		55	48	47	90	51	45	41	30	15

Source: CC.

TABLE 43 **Summary statistics of real audit fees and changes in real audit fees, non-FTSE-companies, 2001 to 2010**

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
										£'000
Real audit fee										
Median	142	145	160	183	198	206	216	269	253	226
Mean	250	317	294	314	351	384	385	421	474	403
Min	3	8	9	10	11	2	2	2	2	2
Max	3,062	14,538	3,904	5,662	5,644	11,014	9,025	11,633	11,858	11,762
										per cent
Real audit fee change										
Median		3	5	6	9	3	3	1	–3	–4
Mean		19	14	32	37	17	16	21	20	–1
10th percentile		–21	–15	–16	–14	–30	–27	–24	–27	–25
90th percentile		56	48	60	81	60	60	45	32	19

Source: CC.

TABLE 44 **Median real audit fee within industry, FTSE 350 companies**

£'000

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Oil & Gas	183	182	190	201	251	315	264	265	302	344
Basic Materials	422	433	444	420	444	537	485	671	710	797
Industrials	317	415	410	404	495	481	477	543	524	508
Consumer Goods	245	284	308	302	379	326	319	304	289	257
Health Care	158	172	228	221	267	235	232	289	266	273
Consumer Services	212	259	261	295	299	300	322	302	355	338
Telecommunications	474	384	401	247	1,066	1,320	1,394	1,101	1,349	1,381
Utilities	686	831	754	655	1,088	768	843	831	661	593
Financials	163	208	103	140	142	192	281	455	178	178
Technology	172	194	222	302	303	226	249	272	381	434

Source: CC.

TABLE 45 **Five-year rolling switching rates by index designation**

per cent

	2001–05	*2002–06*	*2003–07*	*2004–08*	*2005–09*	*2006–10*
FTSE 350	2.2	2.4	2.8	2.5	2.6	2.6
FTSE 100	1.9	1.4	1.9	1.4	1.8	2.0
FTSE 250	2.4	2.8	3.1	2.9	2.9	2.9
Non-FTSE-350	4.3	4.9	5.3	5.6	5.9	5.5

Source: CC.

TABLE 46 **Five-year rolling switching rates by industry, FTSE 350 companies**

per cent

	2001–05	*2002–06*	*2003–07*	*2004–08*	*2005–09*	*2006–10*
Oil & Gas	1.9	3.2	2.8	2.4	1.1	3.1
Basic Materials	0.0	0.0	1.3	1.2	2.2	1.9
Industrials	2.6	3.2	3.2	1.7	2.0	2.0
Consumer Goods	0.0	0.6	2.4	2.6	3.4	3.6
Health Care	6.0	2.2	0.0	0.0	0.0	0.0
Consumer Services	3.6	2.6	2.7	2.6	1.8	2.5
Telecommunications	2.9	3.0	3.0	3.0	3.2	3.3
Utilities	3.2	3.3	3.4	3.4	3.6	2.0
Financials	1.3	2.4	2.9	3.0	3.6	3.1
Technology	3.1	3.4	3.3	3.2	3.0	2.8

Source: CC.

TABLE 47 **Tenure of current auditor within different index designations**

per cent

	0–2 yrs	*3–5 yrs*	*6–10yrs*	*11–20 yrs*	*>20 yrs*
FTSE 350	7.5	13.3	22.6	33.0	23.5
FTSE 100	6.0	9.0	18.0	36.0	31.0
FTSE 250	8.2	15.1	24.5	31.8	20.4
Non-FTSE 350	11.3	20.5	29.8	26.5	11.9

Source: CC.

TABLE 48 **Ratio of real non-audit service fees/real audit and audit-related fees by index designation**

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
FTSE 350	1.65	1.17	0.86	0.69	0.57	0.50	0.51	0.52	0.49	0.48
FTSE 100	1.71	1.13	0.82	0.62	0.52	0.43	0.48	0.50	0.47	0.46
FTSE 250	1.47	1.29	0.98	0.89	0.71	0.73	0.62	0.60	0.57	0.56
Non-FTSE-350	1.70	1.20	1.15	0.96	0.98	0.91	0.81	0.67	0.68	0.70

Source: CC.

TABLE 49 **Staff grade share of engagement hours by index designation 2011**

per cent

	FTSE 350	*FTSE 100*	*FTSE 250*	*Non-FTSE 350*
Partner	5.1	5.3	4.6	4.0
Director	2.6	2.7	2.4	2.2
Senior manager	10.6	10.9	10.1	9.0
Manager	13.7	14.4	12.5	11.8
Other qualified	23.8	23.6	24.4	25.0
Trainee	42.8	41.6	45.3	47.2
Administrative	1.3	1.6	0.8	0.9

Source: CC.

TABLE 50 **Annual staff grade share of engagement hours, FTSE 350 companies**

per cent

	2006	*2007*	*2008*	*2009*	*2010*	*2011*
Partner	5.2	5.0	5.0	5.3	5.2	5.1
Director	2.4	2.6	2.8	3.0	2.6	2.6
Senior manager	11.4	10.3	10.2	10.5	10.4	10.6
Manager	14.5	14.9	14.0	13.9	12.8	13.7
Other qualified	24.8	22.7	20.3	20.5	23.4	23.8
Trainee	39.7	42.5	45.8	44.7	43.8	42.8
Administrative	2.0	2.0	2.0	2.0	1.8	1.3

Source: CC.

TABLE 51 **Staff grade proportion of engagement hours by audit firm across FTSE 350 engagements 2011**

per cent

	PwC	*KPMG*	*Deloitte*	*EY*	*BDO*	*GT*
Partner	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Director	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Senior manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other qualified	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Trainee	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Administrative	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC.

TABLE 52 **Staff grade proportion of engagement staff cost by audit firm across FTSE 350 engagements 2011**

per cent

	PwC	*KPMG*	*Deloitte*	*EY*	*BDO*	*GT*
Partner	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Director	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Senior manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other qualified	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Trainee	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Administrative	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC.

TABLE 53 **Average fee per hour by index designation**

£

	2006	*2007*	*2008*	*2009*	*2010*	*2011*
FTSE 350	95	93	92	95	88	81
FTSE 100	99	98	97	102	94	86
FTSE 250	87	85	82	83	76	71
Non-FTSE-350	88	86	85	77	78	69

Source: CC.

TABLE 54 **Audit firm fee per hour across engagements, FTSE 350 companies**

£

	2006	*2007*	*2008*	*2009*	*2010*	*2011*
PwC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
KPMG	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Deloitte	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
EY	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
BDO	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
GT	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC.

TABLE 55 **Changes in fee per hour and composition of engagement team before and after a switch, FTSE 350 companies**

	0	*1*	*2*	*3*	*4*
Number	19	19	13	6	5
Fee per hour (£)	78.8	51.8	59.2	64.9	61.3
					per cent
Change in hours		24.3	31.5	14.3	8.2
Change in fee		–18.2	–8.8	–12.5	–24.1
Change in fee per hour		–34.2	–30.6	–23.5	–29.8
Proportion of engagement hours by grade					
Partner	3.9	4.7	4.6	4.9	4.5
Director	2.0	4.4	5.2	2.9	2.6
Senior manager	8.7	10.3	10.2	10.8	10.0
Manager	13.5	13.7	16.2	16.0	15.7
Other qualified	23.2	23.4	18.9	17.9	14.8
Trainee	46.8	42.7	44.2	46.9	51.8
Administrative	1.8	0.7	0.6	0.5	0.5

Source: CC.

TABLE 56 **Changes in fee per hour and composition of engagement team before and after a switch, non-FTSE-350 companies**

	0	*1*	*2*	*3*	*4*
Number	29	29	22	14	2
Fee per hour (£)	87.3	58.3	62.8	56.4	78.2
					per cent
Change in hours	0.0	8.4	17.3	15.4	213.2
Change in fee	0.0	–27.6	–16.8	–22.9	144.1
Change in fee per hour	0.0	–33.2	–29.0	–33.2	–22.0
Proportion of engagement hours by grade					
Partner	4.1	3.4	3.3	3.5	9.6
Director	2.8	3.0	2.5	2.5	0.2
Senior manager	9.2	10.9	8.9	7.3	7.6
Manager	13.5	10.1	8.0	10.1	16.0
Other qualified	25.1	24.7	26.7	24.5	37.3
Trainee	44.3	47.4	49.8	51.4	28.9
Administrative	1.0	0.5	0.7	0.7	0.5

Source: CC.

TABLE 57 **Audit firm RRR across FTSE 350 engagements**

per cent

	2006	*2007*	*2008*	*2009*	*2010*	*2011*
PwC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
KPMG	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Deloitte	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
EY	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
BDO	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
GT	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC.

TABLE 58 **Audit firm staff grade scale rates across FTSE 350 engagements 2011**

£

	PwC	*KPMG*	*Deloitte*	*EY*	*BDO*	*GT*
Partner	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Director	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Senior manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Manager	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other qualified	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Trainee	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Administrative	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC.

Contingency tables

1. In this annex, we report the contingency tables upon which the observations in the main text are based. We report the frequencies and the proportions of companies that did and did not switch in the last ten years within each company characteristic.

2. We test for an association between each company characteristic and whether a company has switched using Pearson's chi-squared test. This test compares the *observed* distribution of companies that have and have not switched across the company characteristic with the distribution we would *expect* to observe if the company characteristic was independent of whether a company had switched audit firm or not. We report the chi-square test statistic and the associated p-value. The p-value represents the probability of getting a chi-square test statistic at least as large as the statistic observed if the company characteristic and whether a company has switched audit firm or not are independent of each other. The lower the p-value obtained, the more likely it is that there is an association between the characteristics. We conclude there is an association if the p-value is smaller than 0.05.

TABLE 1 **Company index designation at the beginning of the ten-year period**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
FTSE 100	12	65	16	84
FTSE 250	56	119	32	68
Other listed	53	88	38	62
Private	51	75	40	60
Chi-sq statistic	15.1			
p-value	0.002			

Source: CC analysis of public data set.

TABLE 2 **Private and listed status during the ten-year period**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
Private only	38	48	44	56
FTSE 350 only	30	138	18	82
FTSE 350 and Other listed	61	113	35	65
Listed to private	30	21	59	41
Private to listed	13	27	33	68
Chi-sq statistic	37.9			
p-value	0.000			

Source: CC analysis of public data set.

TABLE 3 **FTSE 350 status during the ten-year period**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
FTSE 350 throughout period	30	138	18	82
Never a FTSE 350 company	60	67	47	53
Moved into FTSE 350	21	57	27	73
Left FTSE 350	32	32	50	50
Moved in and out of FTSE 350	29	53	35	65
Chi-sq statistic	38.9			
p-value	0.000			

Source: CC analysis of public data set.

TABLE 4 **Company industry**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
Basic Materials	1	8	11	89
Banks	0	8	0	100
Consumer Goods	15	35	30	70
Consumer Services	43	73	37	63
Health Care	10	8	56	44
Industrials	38	73	34%	66
Insurance	9	9	50	50
Mining	2	7	22	78
Oil & Gas	5	10	33	67
Other financial services	26	71	27	73
Real estate	2	6	25	75
Technology	14	26	35	65
Telecommunications	5	7	42	58
Utilities	2	6	25	75
Chi-sq statistic	16.6			
p-value	0.219			

Source: CC analysis of public data set.

TABLE 5 **Median company real total turnover during the ten-year period**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
Smallest 20% of companies	36	68	35	65
2nd	40	64	38	62
3rd	38	65	37	63
4th	39	65	38	63
Largest 20% of companies	18	85	17	83
Chi-sq statistic	14.4			
p-value	0.006			

Source: CC analysis of public data set.

TABLE 6 **Number of countries requiring an audit**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
1	39	84	32	68
1-5	37	66	36	64
6-20	31	78	28	72
21-50	20	54	27	73
51+	3	22	12	88
Chi-sq statistic	6.2			
p-value	0.185			

Source: CC analysis of engagement and public data sets.

TABLE 7 **Median number of partners on UK part of audit**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
1-2	25	34	42	58
3-5	53	97	35	65
6-10	50	113	31	69
11+	8	74	10	90
Chi-sq statistic	22.4			
p-value	0.000			

Source: CC analysis of engagement and public data sets.

TABLE 8 **Any merger activity during the last ten years**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
No activity	49	101	33	67
Activity	82	198	29	71
Chi-sq statistic	0.53			
p-value	0.468			

Source: CC analysis of public data set and Dealogic data.

TABLE 9 **Number of years company engaged in merger activity**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
None	49	101	33	67
1–2 years	38	78	33	67
3–5 years	35	69	34	66
6–10 years	9	51	15	85
Chi-sq statistic	7.9			
p-value	0.048			

Source: CC analysis of public data set and Dealogic data.

TABLE 10 **Big 4/non-Big-4 audit firm at beginning of ten-year period**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
Non-Big 4	39	19	67	33
Big 4	133	328	29	71
Chi-sq statistic	34.27			
p-value	0.000			

Source: CC analysis of public data set.

TABLE 11 **Audit firm at beginning of ten-year period**

	Number		*Row proportion %*	
	Switch	*No Switch*	*Switch*	*No Switch*
Non-Big 4	39	19	67	33
PwC	58	114	34	66
KPMG	22	84	21	79
Deloitte	18	52	26	74
EY	25	46	35	65
Arthur Andersen	10	32	24	76
Chi-sq statistic	41.3			
p-value	0.000			

Source: CC analysis of public data set.

Full regression output for probit models

1. In Tables 1 to 4 below we show the full regression output for different specifications of the probit model. Table 1 reports the model summaries. Table 2 reports the estimated coefficients. Table 3 reports the average predicted probabilities of a company with a certain characteristic not switching audit firm during the ten-year period for continuous characteristics and Table 4 reports the average predicted probabilities for categorical characteristics.

2. In Table 1, the 'Model Chi2' value is the likelihood ratio test chi-square statistic, a test that at least one of the estimated coefficients is not equal to zero. The 'Prob > chi2' value is the probability of obtaining a 'Model Chi2' value at least as large as the observed test statistic if all of the estimated coefficients were zero. The 'Prob > chi2' values equal to zero (to at least three decimal places) indicates that the coefficients in the models are jointly significant, ie that at least one coefficient in each model is different from zero.

TABLE 1 **Model summaries**

	Model number						
	1	*2*	*3*	*4*	*5*	*6*	*7*
No	411	428	407	423	423	423	407
Log-likelihood	–207.8	–216.7	–200.2	–209.9	–210.5	–209.5	–199.7
Model Chi2	86.1	90.5	95.0	97.2	95.9	98.0	95.9
Prob > Chi2	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Pseudo R2	0.172	0.173	0.192	0.188	0.186	0.190	0.194
							per cent
Proportion of companies not switching	70.1	69.9	70.3	70.0	70.0	70.0	70.3
Proportion of companies not switching correctly predicted	91.7	91.6	90.2	90.9	90.9	90.5	90.6
Proportion of companies switching correctly predicted	39.0	36.4	38.8	39.4	37.8	37.8	37.2
Proportion (combined) correctly predicted	75.9	75.0	74.9	75.4	74.9	74.7	74.7

Source: CC.

TABLE 2 **Model coefficient estimates and levels of statistical significance**

	Model number						
	1	*2*	*3*	*4*	*5*	*6*	*7*
Assets	–0.09	–0.14	–0.09	–0.12	–0.09	–0.12	0.73
Turnover	0.28***	0.27***	0.27**	0.27***	0.29***	0.28***	0.27***
Risk	0.28**	0.34***	0.27**	0.32***	0.29**	0.32***	0.27**
Tenure	0.35***	0.35***	0.36***	0.35***	0.35***	0.35***	0.36***
Company loss in fewer than 6 years (base)			0	0	0	0	0
Company loss in 6 or more years			0.39	0.32	0.36	0.33	0.4
Basic materials (base)	0	0	0	0	0	0	0
Banks			(Dropped—no companies switched)				
Consumer Goods	–0.55	–0.63	–0.58	–0.65	–0.65	–0.89	–0.85
Consumer Services	–0.54	–0.48	–0.65	–0.61	–0.62	–0.97	–1.07
Health Care	–0.65	–0.54	–0.59	–0.53	–0.55	–0.62	–0.69
Industrials	–0.53	–0.55	–0.59	–0.61	–0.58	–0.95	–0.99
Insurance	–0.88	–1.07	–0.91	–1.15	–1.13	–1.22	–0.99
Mining	–0.11	–0.11	–0.24	–0.25	–0.25	–0.23	–0.22
Oil & Gas	–0.5	–0.44	–0.51	–0.47	–0.47	–0.54	–0.59
Other financial services	–0.6	–0.48	–0.67	–0.55	–0.53	–0.86	–1.03
Real estate	–0.11	–0.07	–0.18	–0.12	–0.07	–0.15	–0.22
Technology	–0.41	–0.41	–0.5	–0.55	–0.55	–0.78	–0.76
Telecommunications	–0.18	–0.18	–0.3	–0.26	–0.22	–0.32	–0.36
Utilities	–0.75	–0.67	–0.78	–0.73	–0.73	–0.82	–0.88
Non-Big-4 audit firm at start of period (base)	0	0					
Big 4 audit firm at start of period	0.28***	0.83***					
Non-Big 4 audit firm at start of period (base)			0	0	0	0	0
[✂]			0.63**	0.62**	0.61**	0.16	0.11
[✂]			0.81***	0.86***	0.86***	0.46	0.34
[✂]			1.17***	1.06***	1.12***	0.72	0.78
[✂]			0.6**	0.7**	0.72**	0.36	0.2
[✂]			1.43***	1.41***	1.48***	1.18**	1.17**
Private for 10 years (base)	0	0	0	0	0	0	0
FTSE 350 for 10 years	0.45	0.23	0.56*	0.39	0.48	0.37	0.55*
FTSE 350 and Other listed only	0.45	0.23	0.44	0.28	0.38	0.26	0.42
Moved from listed to private	–0.19	–0.35	–0.15	–0.33	–0.27	–0.36	–0.2
Moved from private to listed	0.82**	0.63*	0.87**	0.74**	0.86**	0.73**	0.86**
No merger activity (base)							
Merger activity in at least 1 year							
No of years with merger activity (logarithm)							
No merger activity (base)	0	0	0	0	0	0	0
Activity in 1–2 yrs	–0.14	–0.3	–0.17	–0.28	–0.21	–0.27	–0.17
Activity in 3–5 yrs	–0.38	–0.55**	–0.44*	–0.56**	–0.5**	–0.55**	–0.44*
Activity in 6–10 yrs	0.06	–0.23	0.03	–0.18	–0.08	–0.15	0.06
1 country requiring an audit (base)	0		0				0
2–5 countries	–0.5		–0.13				–0.14
6–20 countries	–0.6		–0.13				–0.15
21–50 countries	–0.11		–0.24				–0.22
51+ countries	–0.41		0.18				0.17
No of partners on audit team (logarithm)		0.34**		0.21		0.2	
Proportion of partner hours on engagement					0.5		
No of industry clients at beginning of the period (logarithm)						0.18	0.2

Source: CC.

* 90%, ** 95%, *** 99%.

TABLE 3 **Average predicted probabilities of not switching for continuous characteristics, reported at the values of the 25th and 75th percentile of the characteristic and the difference between them**

per cent

	Model number						
	1	*2*	*3*	*4*	*5*	*6*	*7*
Assets							
p25	72.0	72.7	72.4	72.5	72.0	72.6	72.5
p75	67.5	65.7	67.8	66.7	67.5	66.6	67.7
Difference	–4.5	–7.1	–4.6	–5.8	–4.5	–6.0	–4.8
Turnover							
p25	61.1	61.0	62.0	61.5	60.6	61.2	61.8
p75	77.5	76.8	77.2	76.7	77.1	76.9	77.3
Difference	16.4	15.8	15.2	15.2	16.5	15.7	15.5
Risk							
p25	65.8	64.8	66.4	65.2	65.6	65.2	66.4
p75	70.9	70.8	71.1	70.8	70.8	70.8	71.0
Difference	5.0	6.0	4.7	5.6	5.2	5.6	4.7
Tenure							
p25	59.6	59.5	59.7	59.9	59.9	60.0	59.8
p75	80.1	79.3	80.5	79.4	79.4	79.4	80.4
Difference	20.5	19.7	20.8	19.6	19.5	19.4	20.5
No of partners on audit team							
p25		65.9		67.8		67.9	
p75		74.8		73.0		73.0	
Difference		8.9		5.2		5.0	
Proportion of partner hours on engagement							
p25					69.8		
p75					70.2		
Difference					0.3		
Sector experience							
p25						67.0	66.8
p75						74.4	75.2
Difference						7.4	8.5

Source: CC.

Note: p25 = 25th percentile, p75 = 75th percentile.

TABLE 4 **Average predicted probabilities of not switching for categorical characteristics**

per cent

	Model number						
	1	*2*	*3*	*4*	*5*	*6*	*7*
Company loss in fewer than 6 years			69.7	69.5	69.4	69.5	69.7
Company loss in 6 or more years			79.5	77.8	78.8	78.0	79.7
Basic materials (base)	83.3	82.6	84.5	84.1	83.9	88.7	89.5
Banks			(Dropped—no companies switched)				
Consumer Goods	69.4	66.4	70.9	68.4	68.0	69.2	71.8
Consumer Services	69.8	70.6	68.9	69.4	68.9	66.7	65.8
Health Care	66.6	69.1	70.7	71.6	70.8	76.4	76.2
Industrials	70.2	68.6	70.6	69.5	69.9	67.3	68.0
Insurance	59.4	52.2	61.1	52.6	53.0	59.2	68.0
Mining	81.0	80.3	79.5	78.9	78.6	84.8	86.0
Oil & Gas	70.9	72.0	72.9	73.3	73.0	78.3	78.5
Other financial services	68.2	70.9	68.4	71.0	71.3	69.9	67.0
Real estate	80.9	81.2	80.7	81.6	82.5	86.3	86.0
Technology	73.4	72.6	73.1	71.0	70.7	72.2	74.4
Telecommunications	79.2	78.7	78.2	78.5	79.2	83.1	83.5
Utilities	63.5	65.2	65.1	65.9	65.6	71.0	71.1
Non-Big-4 audit firm at start of period	46.8	46.0					
Big 4 audit firm at start of period	73.1	72.9					
Non-Big-4 audit firm at start of period			47.7	47.1	46.7	58.9	61.0
[✂]			68.6	67.6	66.9	64.1	64.6
[✂]			73.7	74.8	74.4	72.8	71.5
[✂]			82.8	80.0	81.2	79.8	82.4
[✂]			67.6	70.2	70.3	70.0	67.4
[✂]			87.9	87.2	88.4	88.9	89.6
Private for 10 years	59.4	64.7	58.4	62.2	59.7	62.7	58.9
FTSE 350 for 10 years	73.0	71.4	75.0	73.5	74.0	73.5	75.0
FTSE 350 and Other listed only	73.1	71.4	71.7	70.6	71.2	70.4	71.6
Moved from listed to private	53.1	53.3	53.4	51.6	50.9	51.0	52.6
Moved from private to listed	82.4	81.6	82.4	82.0	83.0	82.1	82.4
No merger activity	73.1	75.2	73.8	75.1	74.2	75.0	73.7
Activity in 1–2 yrs	69.2	67.0	69.2	67.6	68.4	67.6	69.1
Activity in 3–5 yrs	61.9	59.5	61.2	59.3	60.0	59.4	61.3
Activity in 6–10 yrs	74.7	69.1	74.6	70.4	72.2	71.1	75.2
1 country requiring an audit	71.4		73.0				73.1
2–5 countries	69.7		69.5				69.4
6–20 countries	70.4		69.3				68.9
21–50 countries	65.8		66.3				67.0
51+ countries	76.6		77.6				77.3

Source: CC.

Data sets in the market investigation for statutory audit services

Introduction

1. This appendix provides a description of the data we requested from all firms[1] that audited a FTSE 350 or Top Track 100 company during the period 2006 to 2011, and explains the work undertaken to check and clean the data, the assumptions made and limitations of the data.[2] We compiled two main data sets: the first used data sourced from the internal records of audit firms (the engagement data set) and the second was data from publicly available sources (the public data set).

2. The remainder of the appendix is organized as follows:

   (a) we set out the scope and coverage of the engagement and public data sets;

   (b) we describe how each data set was processed and cleaned; and

   (c) we set out the limitations that apply to each data set.

Scope and coverage of data

3. The data gathered consisted of two separate work streams. The first was data sourced from the internal records of audit firms (the engagement data set), which contained records for all companies that were listed in the FTSE 350 at some point during 2006 to 2011 and in the Top Track 100 during 2006 to 2011. The second was data from publicly available sources (the public data set), which contained records for all companies that were listed in the FTSE 350 at some point during 2001 to 2011 and in the Top Track 100 2006 to 2011. The engagement and public data sets are discussed in turn.

[1] For the remainder of this appendix, 'firm' refers to an audit firm and 'company' refers to an audited entity.
[2] We issued two data requests to all firms

Engagement data set

4. We issued a client data request to all UK firms that audited a FTSE 350 or a Top Track 100 company in the past six years. This initially included BDO, Baker Tilly, Deloitte, EY, GT, KPMG, PKF and PwC. After further research, we extended the request to firms that audited a small number of companies in the Top Track 100.[3] The client data request, which was developed following a series of data meetings with firms, is included in Annex 1 to this appendix. To ensure consistency we excluded information that was not held by all firms, for example staff costs at the client level. The information obtained can be summarized as follows:

   (a) General—company name, industry and audit tenure.

   (b) Audit team information—number of staff and hours worked by grade as well as scale rates (sometimes known as charge-out or billing rates).[4]

   (c) Financial information—total audit fee, UK audit revenue, revenue recovery rate,[5] non-staff engagement-specific costs and UK revenue from non-audit services.

   (d) Other information—lead office, number of UK offices used by the firm in the audit, number of countries in which the company operates, number of countries where audit activity took place, firm's risk assessment of the company and the latter's index designation (ie FTSE 100, FTSE 250, Other listed or Private).

5. We requested data on all companies that were listed in the FTSE 350 during the period 2006 to 2011.[6] Reviews of the FTSE 350 index are published quarterly on the Wednesday after the first Friday of the month in March, June, September and

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[3] The firms were: RSM Tenon (RSM); Crowe Clark Whitehill (CCW); Chantry Vellacott (CV); Moore Stephens (MS); Elman Wall (EW); Cooper Parry (CP); and Beever & Struthers (BS).

[4] The scale rate is what firms seek to recover from their clients for work carried out by staff. It is not the same as staff cost because it includes other overheads and (usually) some profit margin.

[5] The revenue recovery rate is defined as the proportion of engagement team costs (using the firm's scale rates) that is recovered from the client. In the data request, it is calculated by dividing the UK audit fee by the engagement cost (the latter equals hours worked multiplied by the scale rate for each staff grade).

[6] A list is provided in Annex 2. The six-year period was chosen based on the availability of the data held by firms. Whilst it would have been preferable to gather data over a longer period, 2006 was the earliest year for which all firms could supply data.

December.[7] We also requested the same data for all companies that were in the Top Track 100[8] for at least one year in 2006 to 2011.[9]

6. The request for data encompassed 154 private companies, based on the Top Track lists, and 577 FTSE listings. However, the latter was not equivalent to 577 companies as some companies listed more than one type of share (eg Royal Dutch Shell issued Class A and Class B shares, meaning it was listed twice) whilst others had separate listings for certain subsidiaries. Using data submitted as part of the public data set (see next section), we established that there were 542 companies in the FTSE 350 during the period 2006 to 2011. Further, there were some duplicates in the FTSE 350 and Top Track lists, meaning that the original data request actually encompassed 675 companies (542 FTSE plus 133 Top Track).

7. We received submissions for 664 unique companies. The remaining companies were omitted for primarily two reasons: not all of the smaller firms with a Top Track client were able to respond to our data request; and some firms did not have historic records of companies that were acquired (see paragraph 19). Table 1 shows the number of submissions by audit firm.

TABLE 1 **Number of audit clients submitted**

BDO	*BS*	*BT*	*CCW*	*CP*	*CV*	*DEL*	*EY*	*GT*	*KPMG*	*MS*	*PKF*	*PWC*	*RSM*
23	1	2	3	1	1	175	131	22	178	2	3	227	2

Source: CC data request.

Note: This table adds up to more than 664 due to auditor switching and firms providing data on non-statutory audit services.

8. Some companies were audited by a non-UK member of a firm's network, meaning that the UK firm did not hold any engagement data. In these cases, we received

[7] www.ftse.com/Media_Centre/press_packs/uk_review.jsp.
[8] The Top Track 100 ranks Britain's biggest private companies by sales. Further details can be found in the 2011 research report www.fasttrack.co.uk/fasttrack/downloads/2011toptrack100rep.pdf whilst historic lists can be found at www.fasttrack.co.uk/fasttrack/leagues/top100programme.html.
[9] A list is provided in Annex 3.

partial data responses which included general company information and the total audit fee, but there was no information on staff numbers/hours.

Public data set

9. In addition to the data request above, it was necessary for us to gather publicly available data on large listed and unlisted companies. The reasons for this were:

   (a) the need for company-specific information, such as turnover and assets. Such information was not systematically and routinely held by all audit firms;

   (b) the data request only went back to 2006; and

   (c) firms only held data at the UK level. The engagement data set provided only a partial picture for large companies that had global operations.

10. There were a number of sources that provided the required company-level information, including Bloomberg, Thomson Reuters, FAME and ICC.[10] Our intention was to use one or more of these sources. However, a number of parties raised concerns about the reliability of these data sets including PwC,[11] Deloitte[12] and KPMG,[13] while the problems with FAME were discussed in the OFT's econometric analysis.[14] We were told that publicly available data on audit fees was particularly prone to inaccuracies. For example, PwC found that 33 per cent of audit fee entries in a sample of FAME entries that it examined showed significant inaccuracies.[15]

11. Using ICC rather than FAME, and based on a small number of checks, we found that data on audit fees was not always the same as the figures in companies' annual accounts. This was likely to be due a combination of keying errors and inconsistent

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[10] FAME and ICC are privately maintained databases that contain financial information on companies in the UK and Republic of Ireland. The information is collated from a variety of sources, including companies' filings with Companies House.
[11] PwC response to the issues statement, Section 4. Review of Oxera report www.pwc.co.uk/assets/pdf/pwc-competition-and-choice-in-the-uk-audit-market-a-review-of-the-oxera-report.pdf.
[12] Deloitte response to the issues statement, paragraph 3.4.
[13] KPMG response to the issues statement, Annex 3.
[14] www.oft.gov.uk/shared_oft/freedom_of_information/audit-econometric-summary.pdf.
[15] PwC response to the issues statement, p79, fn177.

data entry. With regard to the latter, publicly listed firms may have reported the following information in their annual accounts:

(a) fees payable to the auditor(s) for the audit of the company's annual accounts;

(b) fees payable to the auditor(s) for the audit of the company's subsidiaries;

(c) total audit fees (equal to *(a)+(b)*); and

(d) fees payable to the Company's auditors and its associates for other services (this is often split between key services, eg tax and 'other').

12. Where we found errors in the ICC data, it was due to the information being inconsistently recorded. For example, in one year the audit fee may have included *(a)* + *(b)* but in the following year it only includes *(a)*. The treatment of audit-related services was also inconsistent, as it was sometimes incorporated in the fees paid to the auditor for non-audit services.

13. There were other problems with public databases, for example, some only recorded single auditors for companies that had shared or joint audits. The identity of the auditor could also be inaccurate due to companies operating under different financial years.

14. We and the parties agreed on the need for a data set that was reliable and accurate, within the time and resource limitations of our inquiry. We therefore discussed potential options with the relevant firms for producing a better quality database.[16] The firms submitted a joint proposal to construct a common data set consisting of companies that were members of the FTSE 350 in the period 2001 to 2011, some 712 companies. All audit firms that had FTSE 350 clients in this period were responsible for collating and checking the information in relation to their own clients. Where a

[16] By 'relevant firms' we refer to the audit firms that accounted for the vast majority of FTSE 350 audits during the period 2001 to 2011. These are: Baker Tilly, BDO, Deloitte, EY, GT, Kingston Smith, KPMG, Mazars, PKF and PwC. All of these firms were invited to a meeting with the CC. Baker Tilly, Kingston Smith and PKF did not attend.

company was not audited by one of the relevant firms, we obtained the data. Deloitte submitted a template to form the basis of the collection exercise.

15. We accepted this proposal but extended the coverage of the data set to include members of the Top Track 100 in the period 2006 to 2011. Following further comments from audit firms we circulated a revised template, which included additional variables.[17] The data included:

(a) general information: company name, industry, company status in each quarter (ie FTSE 100, FTSE 250, Other Listed, Private or Inactive) and financial year-end;

(b) audit information: auditor name, year of first engagement, fees for audit and audit-related services (split by parent and subsidiaries where possible[18]) and non-audit fees;

(c) information on income: total turnover, UK turnover (where available), profit/loss before tax;

(d) information on balance sheet: current and non-current assets and liabilities,[19] equity and inventories;[20]

(e) qualification in the audit opinion; and

(f) information on changes to the company (eg mergers and acquisitions, name changes).

Processing and cleaning

Engagement data

16. With regards to the engagement data set, each firm submitted data using the template in Annex 1. We developed Excel macros to extract the data into one file per

[17] The template is provided in Annex 4 to this appendix. It includes an 'Instructions' sheet that firms used to ensure data was gathered on a consistent basis.
[18] Where the information was available, fees were also provided for audit-related services only.
[19] For financial services companies' total assets and total liabilities are recorded under 'non-current'.
[20] The CC also requested information on receivables and payables but, upon receiving the data, it was found to be unreliable. This is mainly due to the fact that companies do not report these items in the same way in their financial statements.

firm before combining everything into a panel data set. This is illustrated in Table 2 below.

TABLE 2 **Illustration of CC data set**

Auditor	*Client*	*Industry*	*Engagement*	*Year*	*Partner numbers*	*Partner hours*	*Partner scale rates*	*Market*
Auditor A	Client A	Industrials	2001	2006	a	b	c	Other listed
Auditor A	Client A	Industrials	2001	2007	d	e	f	FTSE 250
Auditor A	Client A	Industrials	2001	2008	h	i	j	FTSE 250
Auditor A	Client A	Industrials	2001	2009	k	l	m	FTSE 250
Auditor A	Client A	Industrials	2001	2010	n	o	p	FTSE 100
Auditor A	Client A	Industrials	2001	2011	q	r	s	FTSE 100
Auditor A	Client B	Financials	1997	2006	t	u	v	Private
Auditor B	Client C	Oil & Gas	2005	2006	w	x	y	Other listed

Source: CC.

17. Checks were taken to ensure that the data was successfully imported from Excel into Stata, for example comparing averages and summations of certain variables in both formats. The data-checking process also required us to look at individual companies throughout, allowing us to compare the information in Stata with the raw data submitted in Excel.

18. Using the combined data received from individual firms, we carried out a checking and cleaning exercise. During this process, we encountered a number of issues that required further information or clarification. These are set out and discussed below:

(a) missing companies;

(b) missing data;

(c) non-statutory audit work;

(d) year of initial engagement;

(e) staff hours;

(f) scale rates; and

(g) missing and zero values.

Missing companies

19. We compared the companies for which we received data with the original list of companies we circulated to identify any missing entries. The majority were subsequently included but it was not possible to obtain historic data on all companies due to the way some audit firms maintained their information systems. Specifically, in instances where a company was acquired by another entity, records for the former were often transferred to the acquirer, resulting in all historic information for the target being subsumed into the acquirer's history. In this case, it was not possible to separate the two. This had implications for considering changes in audit fees and staff hours.

Missing data

20. A number of companies contained missing data for certain years. This was identified primarily by looking at observations (engagements) where the UK audit fee was less than £20,000, as this was unlikely to represent a realistic amount for an audit of a large company.[21] Further checks were carried out to remove from the list of missing records those where there was a valid reason for a small fee, for example in the case of particularly small audits (mostly investment trust clients) and when firms just started or ended their auditor relationship (eg due to a switch, the company being taken over, newly-incorporated business etc). In the latter case, a small amount of audit work was recorded due to differences in the client's and firms' financial years.

21. Once these valid observations were excluded, we were left with the missing or incomplete entries. After putting these back to the relevant firms, a number were subsequently updated whilst others could not be completed due to the reasons

[21] We considered applying another filter based on hours worked but due to the differences in year-ends, this was not an appropriate method.

discussed in paragraph 19. Also, as discussed in paragraph 8, we did not have detailed data on companies that are audited by a non-UK firm.

Non-statutory audit work

22. Due to the way some firms managed their business lines, there were instances where data was submitted because the firm carried out audit-related work for a company but was not the statutory auditor. It was difficult to filter these observations out due to the differences in financial year-ends. We therefore combined the engagement data with the public data set in to identify the statutory auditor in a given year.

Initial engagement

23. The data request included the year in which the firm first audited the company. For a number of clients, this was either not specified or a range was given (eg 'pre-1990' or '1970s'). We acknowledged that such information was unlikely to be maintained for long-term clients. We therefore asked firms, as part of the public data set, to specify the exact year for any audit appointment that started during the past 20 years. For earlier periods, a more general approximation was provided using five-year bands (ie 1985 to 1989, 1980 to 1984 etc). Where such estimates were given, we created an 'Approximate Date' (DA) indicator variable.

Staff hours

24. We identified outliers in the data by looking at maximum and minimum values for each firm, in addition to observations that were less/greater than the 10th and 90th percentiles respectively. The majority of these appeared valid, for example fewer hours in the audit of investment trusts and a large number of hours in the audit of large financial institutions. However, in some cases, hours took a negative value.

25. Having clarified this with the relevant firms, negative hours were observed when the firm's staff recorded audit hours to a timesheet but subsequently transferred it to another engagement or service line (or to another year). This could be because hours were logged to an incorrect record or because the engagement was set up under the wrong service line. After the transfer it could leave hours as negative. However, there were very few observations where this occurred and so it did not materially affect the data set as a whole. We did not therefore make any adjustments to the data provided.

Scale rates

26. We identified outliers in the data by looking at maximum and minimum values for each firm, in addition to observations that were less/greater than the 10th and 90th percentile. The majority of these appeared valid, but there were some cases where scale rates were negative or took exceptionally large values.

27. Having clarified this with the relevant firms, negative scale rates could arise for the same reason as negative hours, ie time being incorrectly recorded and transferred to another engagement. This could also result in negative revenues and a negative revenue recovery rate. As with staff hours, there were very few observations where this occurred and so it did not materially affect the data set as a whole.

28. There were also some observations where scale rates for 'Administrative' staff were high compared with professional staff on the audit engagement. The reason for this was that the grade occasionally captured a senior member of non-client service staff, for example an employee from the Consulting or Corporate Finance service line.

Missing and zero values

29. It was important to distinguish correctly between missing and 'zero' entries. In the engagement data set, data on staff numbers, hours and scale rates should be missing only in years where the auditor did not carry out any audit work. If this was not the case, there should be no missing values.

30. To achieve this we applied the following rule—where the variable 'Total Hours' (E7 in the template—see Annex 1) was missing or took a zero value, we removed the latter and made all staff information missing (ie P1–P4 and E1–E6). We also made F4 (Direct non-staff costs) and F5 (International firm costs) missing as well as all 'Other information' variables. If E7 did not equal zero, then any missing value in P1–P4, E1–E6, F4 and F5 was converted to zero. With regards to revenues from non-audit services (F6), these always took a numerical value unless the firm was unable to classify certain services in the categories we provided. Fee data (F1 and F2) was not changed due to the differences in financial year-ends.

Public data set

31. The public data set represented a collaborative effort by the relevant firms and us. The template included instructions that defined each variable. Each contributor was responsible for collecting and verifying its own data. Where a company was audited by more than one firm during the past 11 years, the second firm also conducted a check of the data. A description of steps undertaken during cleaning of the data is provided in Annex 5 to this appendix.

Limitations of data

Engagement data

32. This section explains some important caveats we kept in mind when using the engagement data. These are set out and discussed below:

(a) accuracy of hours;

(b) international audits;

(c) different year-ends; and

(d) staff costs.

Accuracy of hours

33. Our expectation was that all individuals working on an audit completed their time-sheet with the number of hours worked on that client. Academic research has indicated that auditors are affected by different incentives to both over- and under-record the number of hours worked on an audit.[22] As audits were largely fixed-fee engagements, there was limited incentive to increase chargeable hours beyond any target metric required by the firm to meet performance objectives. However, there may have been pressure to under-report hours if firms had strict revenue recovery targets. As we have no method of controlling for under- or over-reporting, we assume that all firms were affected equally.[23]

International audits

34. As discussed earlier, the data request was restricted to audit activities performed in the UK as firms did not have data on staff inputs for their international networks. We collected data on International Firm Costs (F5), which reported the fees billed by the UK firm on behalf of non-UK firms. However, these invoices were only submitted if the client did not engage the non-UK audit firm directly; in many cases a non-UK firm would bill the client directly for work it performed. This variable was used, where appropriate, to subtract from the UK audit fee[24] (F1) to calculate the revenue gener-

[22] See, for example, Breda Sweeney, Bernard Pierce, (2006) 'Good hours, bad hours and auditors' defence mechanisms in audit firms', *Accounting, Auditing & Accountability Journal*, Vol 19 Iss: 6, pp858–892; Agoglia, Christopher P, Hatfield, Richard C and Lambert, Tamara A, When do Audit Managers Prefer Staff to Underreport Time? (June 09, 2011). Available at SSRN: http://ssrn.com/abstract=1625510.

[23] This is particularly the case if employees are not compensated for additional hours beyond contracted working patterns through either overtime or time off in lieu.

[24] Except for PwC and Deloitte, which did not include work performed by non-UK audit firms (regardless where it is billed from) in the UK audit fee (F1).

ated by UK work in cases where the former included work performed by international firms.

35. We also requested data on the number of countries in which the company had business operations (O3) and the number of countries in which an overseas network firm contributed to the audit engagement (O4). The purpose of these variables was to gain a better understanding of the international scope of the audit. O4 was obtained from firms' internal audit files whilst O3 was drawn from a variety of sources, for example audit files, companies' annual returns and marketing documents. In some cases, the number of countries in which a company operated may not be precise but it still provided a reasonable indicator of international scale. The public data set also included separate fields for UK and total turnover but, as companies are not required to report country-specific turnover, the UK data was not comprehensive.

Different year-ends

36. The firms provided data on the basis of their financial years, which are presented in Table 3.

TABLE 3 **Financial year-ends***

BDO	1 Jul
BS	30 Sep
BT	31 Mar
CCW	31 Mar
CP	30 Apr
CV	30 Jun
DEL	31 May
EY	1 Jul
GT	30 Jun
KPMG	30 Sep
MS	30 Apr
PKF	31 Mar
PWC	30 Jun
RSM	30 Jun

Source: Analysis of financial statements.

*The firms were: RSM Tenon (RSM); Crowe Clark Whitehill (CCW); Chantry Vellacott (CV); Moore Stephens (MS); Elman Wall (EW); Cooper Parry (CP); and Beever & Struthers (BS).

37. As firms often operated on different year-ends to their clients, it could make it difficult to interpret the data as an audit is carried out over a 12-month cycle, with the timing

of staff hours recognized by the firms' systems as they are recorded on timesheets. Due to the nature of the audit, this work would span either side of the client's year-end and potentially the firm's. Further, some costs related to the next year's audit might be incurred before completion of the current year.

38. For example, if an auditor had a year-end of 30 June and the company had a year-end of 31 December, the audit of the 31/12/2010 financial statement would mostly be captured by auditor data for 2011. However, some of the audit work (for example, audit planning) would take place in the first half of 2010 and so would be recorded in the auditor data for 2010. Where the company had a year-end that just preceded the auditor year-end, the split would be even sharper.

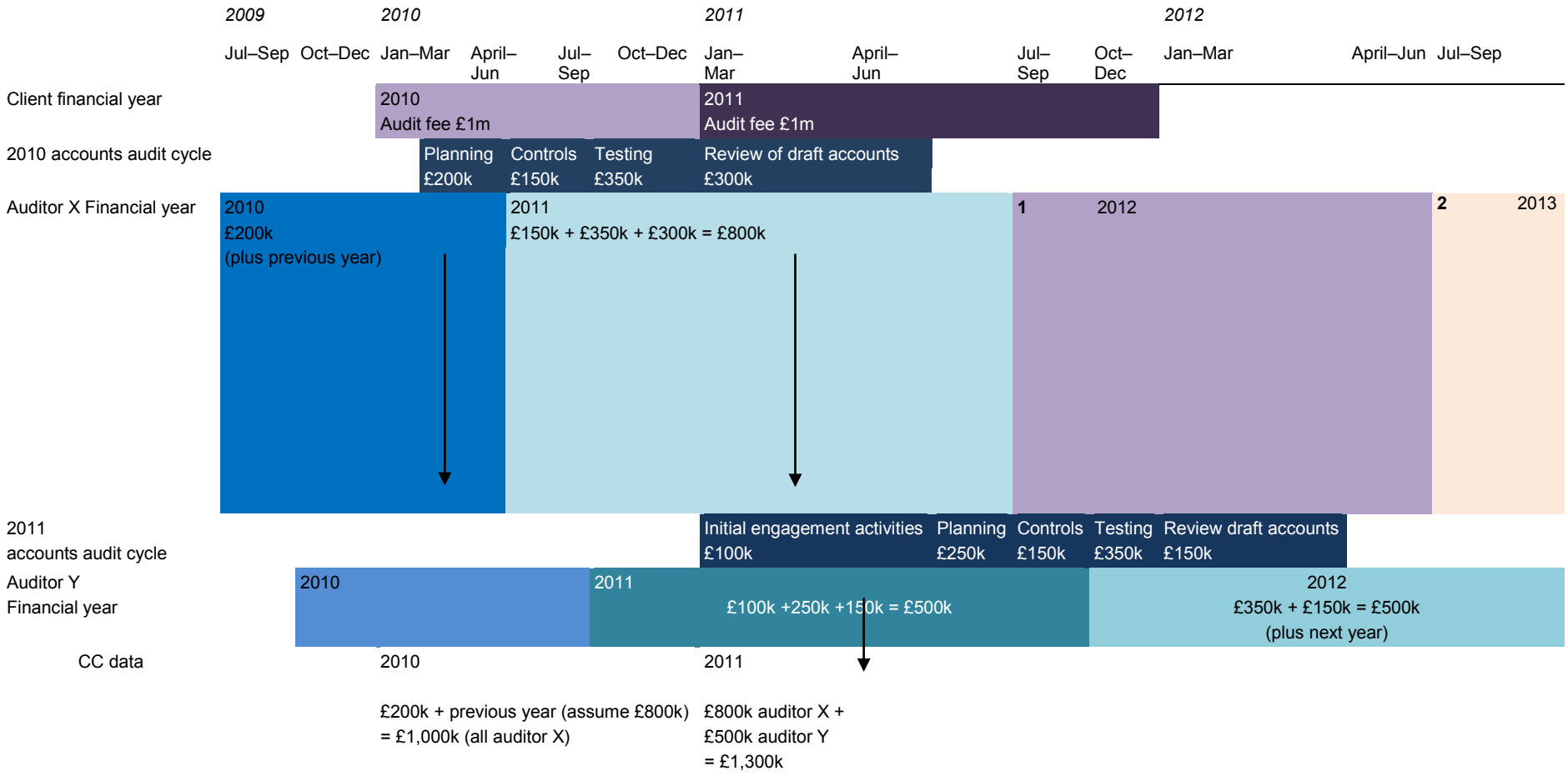
39. It is unlikely that this would be a significant problem where a company used the same auditor for more than six years as the audit work should level out, although in some cases this assumption might not hold (eg if the audit scope changed due to a merger or the sale of a valuable asset). However, it represented a more significant issue when a company switched auditor as the incumbent may record hours before or after the switch took place.

40. For example, if a company had a year-end of 31 December and its auditor X had a year-end of 30 June, most of the work for the 2010 financial statement would be done after 30 June 2010, meaning it was recorded under X's 2011 financial year. However, some work would need to be carried out before this date, which would be recorded under X's 2010 financial year. If the company then switched to auditor Y, with a year-end of 30 September, for its 2011 audit then most of the work would be done in Y's 2012 financial year. However, there would be some work carried out between January to September 2011 (for example, planning, controls testing, review of interim statements) which would fall in Y's 2011 financial year. Therefore the

company had two different auditors recording statutory audit work in the same year (2011). In this case, it would be extremely difficult to identify accurately the staff time (both number and hours) engaged in the company's 2011 audit. Figure 1 below provides an illustration of this problem. This will need to be carefully considered in any analysis of the data.

FIGURE 1

Implications of differing year-ends



Source: CC.
Note: The audit activities described in this figure are not comprehensive. For example, there would be controls and testing work beyond the client financial year as well.

Staff costs

41. The majority of firms did not record staff costs on an engagement basis and so it was not possible to obtain consistent information. As an alternative approach, we asked that firms estimate an hourly cost rate for each staff grade for the past six financial years. The rationale behind this was that the cost rate could be multiplied by the number of hours (by grade) on an engagement to estimate the direct staff cost, which accounted for the majority of costs in delivering an audit. Once we received submissions on this, it became apparent that the calculation of the cost rate depended on an assumption of the number of hours worked.

42. All firms therefore estimated three average hourly staff cost estimates using the average annual cost of each staff grade. This included salary, pensions, national insurance contributions and other staff-specific bonuses and benefits. The cost was divided by the average number of hours worked during the year. This could be calculated on three different bases, using:

(a) standard contract working hours;

(b) chargeable hours, ie total hours in the year that were billed to a client; and

(c) total hours, ie all hours recorded on the employee's timesheet (included chargeable and non-chargeable hours such as business development and training).

43. All firms urged caution in using this information with the client data provided on staff hours as it masked differences within grades, for example regional pay differentials and performance-related pay. The hours reported also did not always distinguish between the function of employees, for example some audit work required specialist advice from tax experts or actuaries. Furthermore, some firms had to aggregate separate internal grades into one overall grade for the data request (eg 'Other qualified'). We have noted these limitations, in addition to the fact that the data did

not include other fixed and common costs, which would be taken into account in any analysis.

Public data

44. This section explains the main caveats associated with the public data set. These are set out and discussed below:

(a) audit fees;

(b) turnover;

(c) non-current liabilities;

(d) equity;

(e) inventories;

(f) receivables and payables; and

(g) treatment of companies post-acquisition.

Audit fees

45. Data for Company Audit Fee, Subsidiary Audit Fee and Audit Related Fees were only populated where data was available in companies' financial statements. Many companies did not report audit fees at this level and so data for these variables was not comprehensive. Further, it was difficult to make comparisons across time and between companies due to changes in financial reporting standards and differences in the way companies reported payments to auditors. The variable 'Total Audit and Audit Related Fees' was, however, considered to be consistent.

Turnover

46. For investment companies, turnover was recorded as income plus investment gains (or losses). In terms of insurance companies, turnover was calculated as gross written and earned premiums less any reinsurance premium paid.

47. With respect to UK turnover, companies did not have to report this on a country-by-country basis and so the data was not comprehensive. Where segmentation was provided on destination and origin bases, the origin basis was recorded.

Non-current liabilities

48. This variable included provisions and charges for some companies in certain industries.

Equity

49. Although we requested that equity data included share capital, retained earnings, minority interests and other reserves, some firms recorded the 'total' equity figure. The data set was not amended for this variation but we do not believe this will lead to material differences.

Inventories

50. Most firms included Work in Progress (WIP) in the inventories data where it was clear from the financial statements that the WIP related to physical inventories. However, some firms included WIP wherever it was identified in the annual accounts. Whilst the data set was not amended for this, there were relatively few instances where it occurred and so we do not believe that it would lead to a material error.

Receivables and payables

51. Although data on these variables was part of the final template, collecting the information on a consistent basis proved difficult. This was because financial statement reporting requirements changed during the past 11 years and the way in which current liabilities and assets may be broken down varied between companies over time. Given the concerns over the reliability of the data, we decided that the data on receivables and payables should be disregarded.

Treatment of companies post-acquisition

52. In the public data set, once a company was acquired there was no data for subsequent years because the financial results were consolidated into the results of the acquirer. This was consistent with the engagement data set.

Client data request template

1	**Name of Audit Client**							
2	**SE Code/TIDM**							
3	**Contact**							
4	**Industry**							
5	**Year of initial engagement**							
6								
7	**Partner information**	**Comments**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
8								
9	P1: Number							
10	P2: Hours worked							
11	P3: Scale Rate (£)							
12	P4: Experience							
13								
14	**Information on engagement team**	**Comments**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
15								
16	E1: Director							
17	E1(a) Number							
18	E1(b) Hours worked							
19	E1(c) Scale Rate (£)							
20	E2: Senior Manager							
21	E2(a) Number							
22	E2(b) Hours worked							
23	E2(c) Scale Rate (£)							
24	E3: Manager							
25	E3(a) Number							
26	E3(b) Hours worked							
27	E3(c) Scale Rate (£)							
28	E4: Other qualified							
29	E4(a) Number							
30	E4(b) Hours worked							
31	E4(c) Scale Rate (£)							
32	E5: Unqualified							
33	E5(a) Number							
34	E5(b) Hours worked							
35	E5(c) Scale Rate (£)							
36	E6: Administrative							
37	E6(a) Number							
38	E6(b) Hours worked							
39	E6(c) Scale Rate (£)							
40	E7: Total Hours							
41								
42	**Financial Information**	**Comments**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
43								
44	F1: UK Audit Fee (£000)							
45	F2: Total Audit Fee (£000)							
46	F3: Revenue Recovery Rate (%)							
47	F4: Direct non-staff costs (£000)							
48	F5: International firm costs (£000)							
49	F6: Fees from non-audit services (£000)							
50	F6(a) Tax							
51	F6(b) Transactions							
52	F6(c) Corporate Finance							
53	F6(d) Restructuring (including Forensics and Business Recovery Services)							
54	F6(e) Consulting							
55	F6(f) Risk Assurance Services							
56	F6(g) IT							
57	F6(h) Other							
58								
59	**Other information**	**Comments**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
60								
61	O1: Lead Office							
62	O2: UK Offices (number)							
63	O3: Client International							
64	O4: Audit International							
65	O5: Client Risk Assessment							
66	O6: Audit-related services							
67	O7: Market							

List of FTSE 350 companies included in the Engagement data request

SE code/ TIDM	*Company name*
888	888 Holdings
3IN	3i Infrastructure
AAL	Anglo American
AB.	Alliance Boots
ABF	Associated British Foods
ABG	African Barrick Gold
ABG	Abbot Group
ABP	Associated British Ports Hldgs
ABR	Absolute Return Trust
ADD	Advance Developing Markets
ADM	Admiral Group
ADN	Aberdeen Asset Management
AFR	Afren
AGA	Aga Foodservice Group
AGK	Aggreko
AGR	Assura
AGS	Aegis Group
AHT	Ashtead Group
AIS	Alternative Investment Strategies
AL.	Alliance & Leicester
ALD	Allied Gold Mining
AMEC	Amec
AML	Amlin
ANTO	Antofagasta
APF	Anglo Pacific Group
AQP	Aquarius Platinum
ARI	Arriva
ARM	ARM Holdings
ASHM	Ashmore Group
ASL	Aberforth Smaller Companies Tst
ATK	Atkins (WS)
ATST	Alliance Trust
AU.	Autonomy Corporation
AUN	Alliance UniChem
AV.	Aviva
AVE	Avis Europe
AVV	Aveva Group
AVZ	Amvescap
AWG	AWG
AXO	Axon Group
AZEM	AZ Electronic Materials
AZN	AstraZeneca
BA	BAE Systems
BAA	BAA
BAB	Babcock International Group
BABS	Bluecrest Allblue Fund (GBP)
BAG	Barr (A.G.)
BARC	Barclays
BATS	British American Tobacco
BAY	British Airways
BB.	Bradford & Bingley
BBA	BBA Aviation
BBAY	BlueBay Asset Management
BBPP	Babcock & Brown Public Partnerships
BBY	Balfour Beatty
BDEV	Barratt Developments
BEE	Baring Emerging Europe
BET	Betfair Group
BEZ	Beazley
BFD	Benfield Group
BG	BG Group
BGC	BTG
BGY	British Energy Group
BHGE	BH Global (EUR)
BHGG	BH Global (GBp)
BHGU	BH Global (USD)
BHME	BH Macro (EUR)
BHMG	BH Macro (GBP)
BHMU	BH Macro (USD)
BI	Brambles Industries
BIFF	Biffa
BKG	Berkeley Group Holdings
BLND	British Land Co
BLT	BHP Billiton
BNKR	Bankers Investment Trust
BNZL	Bunzl
BOC	BOC Group
BOK	Booker Group
BOOT	Boots Group
BOS	Body Shop International
BOY	Bodycote
BP	BP
BPP	BPP Holdings
BPTY	Bwin.Party Digital Entertainme
BRBY	Burberry Group
BRE	Brit Insurance Holdings
BRSN	Berendsen
BRW	Brewin Dolphin Holdings
BRWM	BlackRock World Mining Trust
BSET	British Assets Trust
BSY	British Sky Broadcasting Group
BT.A	BT Group
BTEM	British Empire Sec & General Tst
BTSM	BSS Group
BUMI	Bumi
BUR	Burren Energy
BVIC	Britvic
BVS	Bovis Homes Group
BWNG	Brown (N.) Group
BWY	Bellway
BXTN	Brixton
BYG	Big Yellow Group
CAL	Capital & Regional
CAPC	Capital & Counties Properties
CAT	Cambridge Antibody Tech Group
CBG	Close Brothers Group
CBRY	Cadbury
CCC	Computacenter
CCL	Carnival

CDI	Candover Investments
CEY	Centamin
CGL	Catlin Group Ld
CHG	Chemring Group
CHLD	Chloride Group
CHTR	Charter International
CHU	Chaucer Holdings
CIU	Cape
CKSN	Cookson Group
CLDN	Caledonia Investments
CLI	CLS Holdings
CLLN	Carillion
CLST	Collins Stewart
CNA	Centrica
CNE	Cairn Energy
CNT	Connaught
COB	Cobham
COLT	Colt Group SA
CPG	Compass Group
CPI	Capita Group
CPP	CPPGroup
CPR	Carpetright
CPW	Carphone Warehouse Group
CRDA	Croda International
CRH	CRH
CRST	Crest Nicholson
CS	Corus Group
CSCG	Capital Shopping Centres Group
CSR	CSR
CSTL	Collins Stewart Tullett
CTM	Colt Telecom Group
CTT	Cattles
CTY	City of London Investment Trust
CW.	Cable & Wireless Worldwide
CWC	Cable & Wireless Communications
CWD	Countrywide
CWK	Cranswick
DAB	Dexion Absolute Ld (Ord sterling)
DCA	Detica Group
DCG	Dairy Crest Group
DDT	Dimension Data Holdings

DEB	Debenhams
DGE	Diageo
DGG	Domestic & General Group
DIG	Dunedin Income Growth Inv Tst
DJAN	Daejan Hdg
DLAR	De La Rue
DLN	Derwent London
DMGT	Daily Mail & General Trust (A Shs)
DNLM	Dunelm Group
DNO	Domino Printing Sciences
DNX	Dana Petroleum
DOM	Dominos Pizza
DPH	Dechra Pharmaceuticals
DPLM	Diploma
DRX	Drax Group
DSGI	DSG International
DTY	Dignity
DVO	Devro
DVR	De Vere Group
DVSG	Davis Service Group
DWV	Derwent Valley Hldgs
DXNS	Dixons Retail
EAGA	Eaga
ECM	Electrocomponents
ECWO	Ecofin Water & Power Opportunities
EDIN	Edinburgh Investment Trust
EEN	Emerald Energy
EFM	Edinburgh Dragon Trust
ELM	Elementis
ELTA	Electra Private Equity
EMA	Emap
EMG	Man Group
EMI	EMI Group
ENO	Enodis
ENQ	EnQuest
ENRC	Eurasian Natural Resources Corporation
ERM	Euromoney Institutional Investors
ESSR	Essar Energy
ETI	Enterprise Inns

ETR	Enterprise
EUK	Edinburgh UK Tracker Trust
EUS	Edinburgh US Tracker Trust
EVG	Evolution Group
EVR	Evraz
EXI	Exillon Energy
EXPN	Experian
EXR	Expro International Group
EZJ	Easyjet
FCAM	F&C Asset Management
FCD	First Choice Holidays
FCPT	F&C Commercial Property Trust
FCSS	Fidelity China Special Situations
FCU	Foreign & Colonial Eurotrust
FDL	Findel
FDSA	Fidessa Group
FENR	Fenner
FEV	Fidelity European Values
FGP	FirstGroup
FKI	FKI
FLTR	Filtrona
FOSE	Foseco
FP	Friends Provident Group
FPT	Forth Ports
FRCL	Foreign & Col Invest Trust
FRES	Fresnillo
FSJ	Fisher (James) & Sons
FSV	Fidelity Special Values
FUT	JPMorgan Fleming Cont Eur IT
FWP	Finsbury Worldwide Pharmaceutical
FXPO	Ferrexpo
GCAP	GCAP Media
GEMD	Gem Diamonds
GFRD	Galliford Try
GFRM	Galiform
GFS	G4S
GKN	GKN
GLEN	Glencore International

GLH	Gallaher Group
GMG	Game Group
GND	Gondola Holdings
GNK	Greene King
GNS	Genus
GOG	Go-Ahead Group
GPOR	Great Portland Estates
GRG	Greggs
GRI	Grainger
GRT	Gartmore Group
GSDE	Goldman Sachs Dynamic Opps (Euro)
GSDO	Goldman Sachs Dynamic Opportunities
GSDU	Goldman Sachs Dynamic Opps (USD)
GSK	GlaxoSmithKline
GSS	Genesis Emerging Markets Fund
GUS	GUS
GYG	Gyrus Group
HAMP	Hampson Industries
HAS	Hays
HBOS	HBOS
HDY	Hardy Oil & Gas
HEAD	Headlam Group
HFD	Halfords Group
HGG/HGI	Henderson Group
HHR	Helphire Group
HICL	HICL INFRASTRUCTURE COMPANY
HICL	HSBC Infrastructure Company
HIK	Hikma Pharmaceuticals
HL	Hargreaves Lansdown
HLCL	Helical Bar
HLMA	Halma
HMSO	Hammerson
HMV	HMV Group
HNS	Hanson
HOC	Hochschild Mining
HOIL	Heritage Oil
HOME	Home Retail Group
HRI	Herald Investment Trust
HSBA	HSBC Hldgs
HSD	Hansard Global

HSN	Hansen Transmissions
HSTN	Hansteen Holdings
HSV	Homeserve
HSX	Hiscox
HTG	Hunting
HWDN	Howden Joinery Group
IAG	International Consolidated Airlines Group
IAP	ICAP
ICI	Imperial Chemical Industries
ICP	Intermediate Capital Group
IEC	Imperial Energy Corp
IEM	Impax Environmental Markets
IFD	Invista Foundation Property Trust
IFL	International Ferro Metals
IGG	IG Group Holdings
IHG	InterContinental Hotels Group
III	3i Group
IMG	Imagination Technologies Group
IMI	IMI
IMT	Imperial Tobacco Group
INCH	Inchcape
INF	Informa
INPP	International Public Partnership
INVP	Investec
IOT	iSOFT Group
IPF	International Personal Finance
IPR	International Power
IRV	Interserve
ISAT	Inmarsat
ISYS	Invensys
ITE	ITE Group
ITRK	Intertek Group
ITV	ITV
IVZ	Invesco
JAI	JPMorgan Asian Investment Trust
JAM	JPMorgan American IT
JD	JD Sports Fashion

JDW	Wetherspoon(J D)
JESC	JPMorgan Euro Small Co. Trust
JETG	JPMorgan European Invest Tst (Gwth Shs)
JFF	JPMorgan Eur Fldglng Inv Trust
JFJ	JPMorgan Japanese Inv. Trust
JFJ	JPMorgan Fleming Japanese IT
JFM	JPMorgan Fleming Mercantile IT
JII	JPMorgan Indian Inv Trust
JJB	JJB Sports
JKX	JKX Oil & Gas
JLIF	John Laing Infrastructure Fund
JLT	Jardine Lloyd Thompson Group
JMAT	Johnson Matthey
JMG	JPMorgan Emerging Mkts Inv Trust
JMO	JPMorgan Fleming Overseas IT
JPR	Johnston Press
JRS	JPMorgan Russian Secs
JUP	Jupiter Fund Management
KAZ	Kazakhmys
KCOM	KCOM Group
KEL	Kelda Group
KENZ	Kentz Corporation
KESA	Kesa Electricals
KFX	Kofax
KGF	Kingfisher
KGN	Kensington Group
KIE	Kier Group
KLR	Keller
KMR	Kenmare Resources
LAD	Ladbrokes
LAM	Lamprell
LAND	Land Securities Group
LARD	Laird Group
LGEN	Legal & General Group
LII	Liberty International
LLOY	Lloyds Banking Group
LMI	Lonmin

LMR	Luminar
LMSO	London Merchant Securities
LNGO	Laing (John)
LOG	Logica
LRD	Laird
LRE	Lancashire Holdings
LSE	London Stock Exchange Group
LSP	London & Stamford Property
LWDB	Law Debenture Corp
MAB	Mitchells & Butlers
MARS	Marstons
MAY	Mapeley
MCA	McAlpine (Alfred)
MCB	McBride
MCHL	Mouchel Group
MCRO	Micro Focus International
MCTY	McCarthy & Stone
MEC	Mecom Group
MFI	MFI Furniture Group
MGCR	Morgan Crucible Co
MGGT	Meggitt
MGNS	Morgan Sindall
MKS	Marks & Spencer Group
MLC	Millennium & Copthorne Hotels
MLW	Merrill Lynch World Mining Tst
MNDI	Mondi
MNKS	Monks Investment Trust PLC
MNR	Minerva
MONY	Moneysupermarket.co m Group
MPI	Michael Page International
MRC	Mercantile Investment Tst (The)
MRCH	Merchants Trust
MRO	Melrose PLC
MRS	Melrose Resources
MRW	Morrison (Wm) Supermarkets
MSLH	Marshalls
MSY	Misys
MT.S	MyTravel Group

MTC	Mothercare
MTN	Matalan
MTO	MITIE Group
MUT	Murray Income Trust (Ord)
MYI	Murray International Trust (Ord)
NEX	National Express Group
NFDS	Northern Foods
NG	National Grid
NIS	Northgate Information Solutions
NRK	Northern Rock
NSAM	New Star Asset Management Group
NTG	Northgate
NVA	Novae Group
NWG	Northumbrian Water Group
NWR	New World Resources
NXT	Next
OCDO	Ocado Group
OML	Old Mutual
OPHR	Ophir Energy
ORE	Aricom
OXIG	Oxford Instruments
PAG	Paragon Group of Companies
PAY	Paypoint
PCT	Polar Capital Technology Trust
PDG	Pendragon
PER	Perform Group
PFC	Petrofac
PFD	Premier Foods
PFG	Provident Financial
PFL	Premier Farnell
PHNX	Phoenix Group Holdings
PHTM	Photo-Me International
PIC	Pace
PILK	Pilkington
PLI	Perpetual Income&Growth Inv Tst
PMO	Premier Oil
PNL	Personal Assets Trust
PNN	Pennon Group
POG	Petropavlovsk
POG	Peter Hambro Mining

POLY	Polymetal International
PRTY	Partygaming
PRU	Prudential
PRW	Promethean World
PSN	Persimmon
PSON	Pearson
PUB	Punch Taverns
PVCS	Pv Crystalox Solar
PZC	PZ Cussons
QED	Quintain Estates and Development
QQ	Qinetiq Group
QXL	QXL Ricardo
RAT	Rathbone Brothers
RB	Reckitt Benckiser Group
RBS	Royal Bank Of Scotland Group
RCP	RIT Capital Partners
RDSA	Royal Dutch Shell A
RDSB	Royal Dutch Shell B
RDW	Redrow
REL	Reed Elsevier
REO	Real Estate Opportunities
REX	Rexam
RGU	Regus
RHM	RHM
RIO	Rio Tinto
RMV	Rightmove
RNK	Rank Group
ROR	Rotork
RPC	RPC Group
RPS	RPS Group
RR	Rolls-Royce Holdings
RRS	Randgold Resources
RSA	RSA Insurance Group
RSL	Resolution
RSW	Renishaw
RTN	Restaurant Group
RTO	Rentokil Initial
RTR	Reuters Group
RWD	Robert Wiseman Dairies
SAB	SABMiller
SAT	Second Alliance Trust
SBRY	Sainsbury (J)

SBT	Sportingbet
SCHE	Southern Cross Healthcare
SCIN	Scottish Investment Trust
SCTN	Scottish & Newcastle
SDL	SDL
SDP	Schroder Asia Pacific Fund
SDR	Schroders
SDRC	Schroders N/V
SDY	Speedy Hire
SEG	SCI Entertainment Group
SFR	Severfield-Rowen
SGC	Stagecoach Group
SGE	Sage Group
SGP	SuperGroup
SGR.	Segro (CALL)
SGRN	Segro (NIL PD)
SGRO	Segro
SHB	Shaftesbury
SHI	SIG
SHP	Shire
SIA	Soco International
SIG	Signet Group
SKS	Shanks Group
SL.	Standard Life
SLOU	Slough Estates
SLY	Stanley Leisure
SMDR	Salamander Energy
SMDS	Smith (DS)
SMIN	Smiths Group
SMP	St.Modwen Properties
SMT	Scottish Mortgage Inv Tst
SMWH	WH Smith
SN.	Smith & Nephew
SNR	Senior
SPD	Sports Direct International
SPI	Spice
SPT	Spirent Communications
SPW	Scottish Power
SPX	Spirax-Sarco Engineering

SRP	Serco Group
SSE	SSE
SSL	SSL International
STAN	Standard Chartered
STHR	SThree
STJ	St.James Place
STOB	Stobart Group
SVI	SVG Capital
SVS	Savills
SVT	Severn Trent
SXS	Spectris
SYR	Synergy Health
TALK	TalkTalk Telecom Group
TALV	Talvivaara Mining Company
TATE	Tate & Lyle
TCG	Thomas Cook Group
TCY	Telecity Group
TEM	Templeton Emerging Markets IT
TEP	Telecom Plus
TLNT	Telent
TLPR	Tullett Prebon
TLW	Tullow Oil
TMPL	Temple Bar Inv Tst
TNI	Trinity Mirror
TNN/TNS	Taylor Nelson Sofres
TOMK	Tomkins
TOPE	MW Tops (EUR)
TOPS	MW Tops (GBp)
TPK	Travis Perkins
TPT	Topps Tiles
TRAD	Tradus
TRIL	Thomson Reuters
TRMA	THAMES RIVER MULTI HEDGE PCC (GBP)
TRY	TR Property Investment Trust
TRYS	TR Property Investment Trust (Sigma shs)
TSCO	Tesco
TT	TUI Travel
TW	Taylor Wimpey
TWOD	Taylor Woodrow

UBM	UBM
UKC	UK Coal
UKCM	UK Commercial Property Trust
ULE	Ultra Electronics Holdings
ULVR	Unilever
UTG	Unite Group
UU.	United Utilities Group
VCT	Victrex
VEC	Vectura Group
VED	Vedanta Resources
VMOB	Virgin Mobile Holdings (UK)
VOD	Vodafone Group
VPC	Venture Production
VRD	Viridian Group
VTG	VT Group
WEIR	Weir Group
WG	Wood Group (John)
WHM	Whatman
WIN	Wincanton
WKP	Workspace Group
WLB	Wilson Bowden
WLF	Wolfson Microelectronics
WLW	Woolworths Group
WMH	William Hill
WMPY	Wimpey(George)
WNER	Warner Estate Hldgs
WOLV	Wolverhampton & Dudley
WOS	Wolseley
WPP	WPP
WSH	WSP Group
WSM	Wellstream Holdings
WTAN	Witan Inv Tst
WTB	Whitbread
WUN	Wellington Underwriting
XCH	Xchanging
XTA	Xstrata
YELL	Yell Group
YULC	Yule Catto & Co

List of Top Track companies included in the Engagement data request

Company name
2 Sisters Food Group
20:20 Mobile Group
AA
Acromas
AF Blakemore & Son
Alliance Boots
AMC Group
Anglian Water Group
Arcadia
Arnold Clark Automobiles
Arqiva
Arup
ASCO
Associated British Ports
Aurora Fashions
Balli Holdings
Baxi Group
Bernard Matthews Farms
Bestway Group
bet365
Betfred
BHS
Bibby Line Group
Biffa
Birds Eye Iglo Group
Bloor Holdings
Bmi
BOCM PAULS (Agricola Group)
Booker
Bourne Leisure
Bowmer and Kirkland
Brakes Group
Bristol Street Group
Camden Motor Group
Caparo Group
Caudwell Holdings
City Electrical Factors
Clarks
Coats
Costcutter

Countrywide
CPL Industries
Crest Nicholson
DFS
Doncasters
Dunbia
Dyson
Edwards
EMI
Enterprise
European Metal Recycling
EWS Railway
Expro International
Findus Group
Farmfoods
Firth Rixson
First Quench Retailing
Fitness First
flybe
Formula One
Focus DIY
Four Seasons Health Care
Gala Coral
Gladedale
Grampian Country Food Group
Greenergy
Greenhous Group
Guardian Media Group
Hanover Acceptances
Harrods
Healthcare at Home
House of Fraser
Iceland
Infinis
Ineos Chlor
INEOS Group
JCB
JCT600
John Laing
John Lewis Partnership
KCA Deutag Group

Keepmoat
Kelda Group
Kwik-Fit
Laing O'Rourke
LINPAC
Listers
Lucite International
Mace
Malthurst
Marshall Group
Martin McColl
Matalan
Merlin Entertainments Group
MFI Retail
Miller Group
Monarch Holdings
Monsoon
Moto
Mott MacDonald
MRH (GB)
Murray International
NDS Group
New Look
NG Bailey
Northgate Information Solutions
Northern & Shell Media Group
OCS Group
Odeon & UCI Cinemas Group
Palmer and Harvey
Peacock Group
Pentland Group
Perrys
Phones 4u
PSN
River Island
Ryland Group
Samworth Brothers
SCH Group
Seton House Group
Shepherd Group
Shop Direct Group

Sir Robert McAlpine
Somerfield
Southern Water
Specsavers
Spire Healthcare
Sports World International
SSP
Stemcor
Swire
Telereal Trillium
Thames Water
TI Automotive

TJ Morris
Trailfinders
Travelex
Unipart Group
United Biscuits
Vasanta Group
Vestey Group
Vetco International
Virgin Atlantic
Virgin Trains
Viridian
Vita Group

Wates
Watson Petroleum
Welcome Break
Westcoast
Wilkinson
William Grant & Sons
Willmot Dixon Group
Zavvi

Public data request template

							Company Status (FTSE100, FTSE250, Other listed, Private, Inactive)		
#	Company name per Bloomberg	SE Code/ TIDM	Industry	Primary checker	Secondary checker	Unique identifier	Dec-00	...	Dec-11

Data	Data	Data	Data	Data	Data	Data	Data	Data	Data
			Total	Company	Subsidiary	Audit-Rel.		Total	UK
Year end	Auditor		Audit and Audit Related Fees	Audit Fee	Audit Fee	Fee	Non-audit fees	Turnover	Turnover
Date	Name	Year of first audit engagement	£'000s	£'000s	£'000s	£'000s	£'000s	£'000s	£'000s
Columns for 2000–2011	Columns for 2000–2011		Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011

Table continued

Data	Data	Data	Data	Data	Data	Data	Data	Data	Data
Current	Non-current	Current	Non-Current						
Assets	Assets	Liabilities	Liabilities	Equity	Profit (loss)	Audit	Inventories	Receivables	Payables
£'000s	£'000s	£'000s	£'000s	£'000s	£'000s	Qualification	£'000s	£'000s	£'000s
Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011	Columns for 2000–2011

Note: Each column with heading 'Data' represents an array of columns for years 2001–2011. Every array of data was followed by 'Comments' columns for each variable, for years 2000–2011, which are omitted above for brevity.

Instructions

Data	Source	Instructions	General comments
Company Name	Combination of Bloomberg, Datastream and Top Track.	Please do not amend any company names. If the company changed its name or you believe a different name should be used, please use the 'Company changes' work sheet.	
SE Code/TIDM	FTSE Lists provided by the CC and/or the LSE website*	Does not apply to Top Track companies	
Industry	FTSE Lists provided by the CC and/or the LSE website* **	Please classify companies using the ICB classification system (see attached worksheet 'ICB' for a full list of categories). For listed companies it should be possible to provide the full four-digit code. For Top Track companies, it will be necessary for the audit firm to classify the company. In this case, a three digit-code (to identify sector) will suffice. Firms should particularly refer to the ICB worksheet where the source data is more then 3 years old as some of the classifications have changed (for example Real Estate).	
Unique identifier	Companies house, Bloomberg, ICC or other company databases ***	This should be the company registration number.	Propose to record the company registration number for each period as a check to ensure that the same entity is being used.
FTSE 350 listing/company status	Company lists provided by the CC and/or the LSE website	This should take one of the following categories: FTSE100; FTSE250; Other listed; Private, or; Inactive.	Please record this on a QUARTERLY basis
Financial year end	Company annual statutory accounts and/or audit firm records		Use the 'Comments' array to indicate any unusual periods (e.g. accounting years less or more than 12 months)
Auditor name	Company annual statutory accounts and audit firm records		
Year of first audit engagement	Company annual statutory accounts and audit firm records	If the engagement started in 1990 or after, please give the exact year. If it is not possible to identify the exact year before 1990, please respond with a five-year band (i.e. 1985-1989, 1980-84, 1975-1979 etc). For engagements starting before 1970, ten-year bands will suffice (i.e. 1960-1969, 1950-1959 etc).	The year of initial engagement applies to the current auditor. If the company has switched auditor during the period 2001-2011 please provide the year of initial engagement for the previous auditor in the Comments array. For example, in the case of A.G. Barr the year of initial engagement will be 2010 for KPMG. However, we would also like to know the year of the first engagement for Baker Tilly, which was the previous auditor. This should be provided under 'Comments: Year of first audit engagement'.
Total audit fee and audit related fees	Company annual statutory accounts	Audit and audit related fees should be recorded together. We have agreed a list of 12 services which will be designated as “audit and audit related” services. All other services for which fees are recorded in the financial statements (which are not clearly audit fees) will be recorded in the data set as non-audit fees. As such, in this revised	

		template the audit and audit related fee columns are combined, leaving one column for each year (i.e. there is one column encompassing Group Fees, Subsidiary Fees and Audit Related Fees). A list of these 12 services can be found at the bottom of this spreadsheet. If the company's accounts provide data distinguish between fees for the statutory audit and audit-related fees, please provide this in the Comments array.	
Company Audit Fee	Company annual statutory accounts and audit firm records	This refers to the audit fees payable to the auditor for the audit of the Parent company (it may also include Group financial Statements). Include this when it is provided in the company's annual accounts.	
Subsidiary Audit Fee	Company annual statutory accounts and audit firm records	This refers to the audit fees payable to the auditor for the audit of the the company's subsidiaries. Include this when it is provided in the company's annual accounts.	
Audit Related Fees	Company annual statutory accounts	Include this when it is provided in the company's annual accounts.	
Non-audit fees	Company annual statutory accounts	This should only include non-audit fees paid to the auditor.	
Total Turnover	Company annual statutory accounts	Non-FS: Total revenue as per the face of the income statement. Record total rather than that derived from continuing operations. FS: Total income as per the face of the income statement. Record total rather than that derived from continuing operations	
UK Turnover	Company annual statutory accounts	Include this when it is provided in the company's annual accounts. If UK turnover is given as £0, please insert '0' (do not leave blank).	
Current Assets	Company annual statutory accounts	Non-FS: current assets. FS: Leave blank	
Non-current Assets	Company annual statutory accounts	Current and non-current assets as specified by the CC. FS: record TOTAL ASSETS as per the group balance sheet in the 'Non-current assets' columns.	
Current Liabilities	Company annual statutory accounts	Non-FS: current liabilities. FS: Leave blank	Please record "n/a" where any of this data is not available.
Non-current Liabilities	Company annual statutory accounts	Non-FS: Non-current liabilities. FS: record TOTAL LIABILITIES as per the group balance sheet in the 'Non-current liabilities' columns.	
Equity	Company annual statutory accounts	This includes share capital, retained earnings and other reserves.	
Profit (or loss)	Company annual statutory accounts	This should be profit before taxation.	
Audit Qualification	Company annual statutory accounts	Responses should be a number 1-7. Please use the following key:1. Clean/unqualified 2. Emphasis of matter 3. Qualified opinion - limitation of scope 4. Qualified opinion - disagreement 5. Disclaimer of opinion 6. Adverse opinion 7. Multiple	
Inventories	Company annual statutory accounts	This parameter may not be applicable to FS companies. Please record n/a if the data is not available.	
Receivables	Company annual statutory accounts	Includes both trade and other receivables. This parameter may not be applicable to FS companies. Please record n/a if the data is not available.	
Payables	Company annual statutory accounts	Includes both trade and other payables. This parameter may not be applicable to FS companies. Please record n/a if the data is not available.	

*LSE website with SE Codes FS - Financial services. Non-FS - non-Financial services
**LSE website with historic company data
***Companies House website with registration numbers

Public data set—processing and cleaning[1]

1. One observation in the data set represented one report (set of accounts).

2. The variable 'year' represented the calendar year to which the last day of the report belonged (eg a report with a year ending on 31/12/2007 will have 2007 in the 'year' column). Due to changes in financial year-ends in some calendar years there were no reports filed, and in some calendar years there were two reports.

3. In some cases there were duplicate entries (the same company was mentioned once in FTSE 350 sheet, and once in Top Track sheet)—in these cases only one record was kept and the other was removed. In two cases two records were combined (it was the same company but was listed in one line before a certain year and in another line after that)—companies #610 and #830, and #802 and #792.

4. 'Auditor_name'—in order not to overstate the amount of auditor switching, in cases when an auditor changed its name at some point, or became a part of another firm, the auditors' names were standardized. To identify the names of auditors as submitted please refer to column 'auditor_name_original'.

5. Joint audit—the column 'auditor name' contains the name of only one auditor. Cases of joint audit are flagged in column 'joint_audit'. To identify the names of the joint auditors please refer to column 'auditor_name_original'.

6. 'Gaps' in auditor names—in some cases auditor names were missing for certain years. If the auditor was the same before and after the gap we assumed that the same auditor was the auditor during the gap. Otherwise we checked 'year of initial

[1] Also see the published data set and variable descriptions.

engagement' in the public data set, engagement data set, as well as publicly available sources. Such cases were flagged in column 'auditor_name_note'.

7. Missing year-ends and empty entries. It was not always clear if a company was inactive, or accounts were missing. We used the following approach:
   (a) If a report's year-end was missing, but this was a 'gap' (so there were accounts before and after such a report)—we kept such an observation.
   (b) Otherwise the observation was dropped.

8. Calendar years—we matched each report to a calendar year in which the largest portion of the report's period falls. If a report covered an odd number of days, the calendar year to which the 'middle day' of the report belonged to was assumed to be the calendar year for this report. If a report covered an even number of days, the calendar year to which the last day of the first half of the report belonged to was assumed to be the calendar year for this report.

9. In a small number of cases (usually due to a change in financial year-end of a company) there were two reports belonging to the same calendar year—we merged these reports into one so that there was only one report per calendar year.

10. In a small number of cases (due to a change in financial year-end of a company) there were calendar years without any reports belonging to them—this happened when the change in financial year-end led to an unusually long reporting period. We split such reports into two so that there was only one report per calendar year. Such cases are flagged in column 'special case'.

11. Company status (Inactive, Private, Other listed, FTSE100, FTSE250). For each report columns 'status_q1', 'status_q2', 'status_q3', and 'status_q4' indicated the

status of the company in quarters 1, 2, 3 and 4 of the relevant calendar year (identified according to paragraph 8 above), respectively.

12. Industry—for the cases where a company ceased to exist before the four-digit industry codes were introduced, we assigned a four-digit industry code consistent with the company's industry, sector or super-sector codes under the old classification.

13. Year of first engagement—for each company we ordered its auditors since the year 2000 (auditor #1, #2 etc) according to the first year of the audit engagement. If the auditor was number 2, 3 or 4 we took the year of its first occurrence in the data set as the first year of the engagement. For the 'first' auditors for each company we used the main public data set submissions, as well as the engagement data set to determine the year of first engagement. In a small number of cases when this information was missing, the year of first audit engagement for the first auditor was assumed to be the year of its first occurrence in the data set (eg 2000 if the data for that company started in the year 2000).

14. Confidentiality—in a small number of cases certain data points were deleted before the data set was circulated, when such data was marked as confidential by the audit firm that provided the information.

The role of city institutions: auditor clauses in loan agreements, IPO advisers and private equity houses

Introduction

1. This appendix summarizes the evidence that we obtained on the role of city institutions (other than institutional shareholders) in auditor selection. We considered:

   (a) the role of debt investors and their advisers, including lending banks, law firms and ratings agencies. The investigation into the role of debt investors focused largely on the presence of clauses in loan agreements that require borrowers to have their financial statements audited by certain audit firms. The evidence that we obtained is discussed in the first section of this appendix, and in Annex A; and

   (b) the role of IPO advisers and private equity houses.

Role of debt investors and their advisers

2. We investigated claims that clauses in corporate loan agreements requiring borrowers to have their financial statements audited by one of the Big 4 audit firms (Big 4 clauses) potentially represented a barrier to entry for non-Big-4 firms. In doing so, we conducted a survey of major participants in the market for syndicated loans (ie lenders, the Loan Market Association (LMA), and solicitors) to assess the prevalence, nature and significance of Big 4 clauses. We asked Cardiff Business School (CBS) to analyse the results and write a report, which is published separately on our website[1] and is included as Annex A to this appendix for convenience.

3. The report found that documentation/templates provided by the LMA represented a widespread basis for corporate lending agreements, both syndicated and bilateral. Importantly, of the two main sets of LMA documentation, only one—the Leveraged

[1] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cbs_auditor_clauses_report.pdf.

Loan documentation—contained a Big 4 clause. In this clause, which was optional but often remains intact, auditors were defined as one of the Big 4 firms. There were, however, examples of names of non-Big-4 auditors being added to the clause. The LMA Investment Grade documentation contained no such clause. The main reasons for this clause centred around the expectation of lenders and borrowers that the LMA documentation would be used, the familiarity of the Big 4 firms to international lenders (which often participated in syndicated loans) and the importance of high-quality audit of financial covenants in high leverage transactions.

4. The report noted that it was difficult to define precisely which companies would be exposed to Leveraged Loan documentation but that a small but non-trivial proportion (at least 17) companies in the FTSE 350 would be likely to be affected. In response to the paper, KPMG said that the survey findings and conclusions were broadly consistent with its own experience: it was not an issue for investment-grade loans which predominated in the FTSE 350, but the documentation for leveraged loans could provide the impression of narrowing the choice of audit firms.[2]

5. BDO, in response to the CBS report,[3] said that the effect of such clauses was on companies outside the FTSE 350, whose debt was not then investment grade. BDO said that:

> A change or choice of auditor away from a mid-tier firm to a Big Four firm is imposed on a growing company before it joins the FTSE 350, once it is in the FTSE 350, the company is highly unlikely to reverse that change. Therefore the effect of such requirements is to cut off custom for mid-tier firms and act as a barrier to them auditing present and prospective members of the FTSE 350. The high market share of

[2] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cbs_clauses_in_auditor_loan_agreements_kpmg.pdf.
[3] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cbs_clauses_in_auditor_loan_agreements_bdo.pdf.

the Big Four in the FTSE 350 therefore seems partly responsible for the absence of these clauses within the FTSE 350: those clauses apply most effectively outside the FTSE 350, particularly for companies with the potential to join the FTSE 350.

Role of IPO advisers and private equity houses

6. BDO also told us that it had difficulty retaining companies looking to raise investment capital as audit clients due to pressure from advisers and private equity investors.

7. We investigated these claims as follows:

   (a) We wrote to 20 private equity firms including 16 firms named by BDO and GT and four other large London-based firms.

   (b) We wrote to 15 investment banks listed by Bloomberg as the top IPO underwriters for London listings in 2011.

8. We asked whether they had made recommendations to switch auditor to a Big 4 firm in recent transactions, and if so why. We also asked for views on the identity of the auditor and on what services they would expect the audit firm to supply. Finally we asked about the existence of any preferred supplier agreements with audit firms.

9. We also wrote to two companies ([✂] and [✂]) that had told BDO that they had been pressured by advisers to switch to a Big 4 firm, to ask them about the reasons for the switch.

10. The remainder of this section contains: *(a)* a summary of the responses that we received, followed by reports of the responses on *(b)* auditor identity, *(c)* criteria for assessing suitability of auditors, and *(d)* services required from the audit firm.

Summary of responses

11. We received responses from ten private equity firms and 12 investment banks. Around half the respondents revealed some tendency to favour Big 4 firms, particularly for larger companies. Four respondents indicated a clear preference for Big 4 firms in all circumstances.

12. Only one private equity house cited specific examples where it had required a company to change auditor to a Big 4 firm. Many respondents said that companies were already using Big 4 firms so it was not an issue.

13. No respondents said that they had preferred supplier agreements in place with audit firms. However, one private equity house indicated that it often chose to use a particular Big 4 audit firm.

14. One of the two companies that we wrote to on this subject ([✂]) cited bank advice as one reason for switching auditor to a Big 4 firm. It said that in planning a bond issue, it had been told by its bank group that as a first time issuer, the issue would be better received if the company engaged a Big 4 firm as auditor.

15. The other company ([✂]) said that it selected a Big 4 firm in preference to its existing auditor based on 'cost/service/adaptability to our growth plan and experience of refinancing in the high yield bond market'.

Detailed responses on auditor identity

Investment banks

16. An investment bank ([✂]) said 'Whilst banks working on an IPO may offer recommendations regarding other advisers, the company will usually have chosen an accounting firm before approaching a bank and typically that will be one of the Big 4.'

17. An investment bank ([✂]) said it could not recall any occasions when it had recommended a switch to a Big 4 firm because almost all companies had Big 4 auditors by the time they were close to an IPO, but noted that: 'The likelihood is that if a prospective IPO client had an auditor outside of the Big 4, we would challenge them on that position.' It cited two reasons for this: first 'reputational issues' and secondly the workload involved in an IPO. It said that the IPO process was very onerous and that Big 4 auditors were typically very experienced in the process and could deliver on a tight time frame more easily due to the fact that they were better resourced.

18. An investment bank ([✂]) stated that all the UK IPO transactions that it had been involved with in the last three years had involved companies that already had Big 4 auditors prior to intention of listing.

19. One investment bank ([✂]) said that when it was considering bringing a company to market by way of IPO the identity of the auditors was very important. It said:

> More often than not the auditors are one of the Big 4. However, when the firm is outside that group we debate the point [ ]. Factors we consider are the experience of the firm in question; its client list (ie does it have other audit clients listed on the same exchange); its experience of capital market transactions (eg preparing long form reports, working capital reports and provision of comfort letters); overall market perception and reputation of the firm; and the resources of the firm in terms of people.

It also noted that the same approach was taken outside of IPOs:

> In the event of a transaction where we are required to provide sponsor services, we need to be satisfied that we can rely on the accounting services provided to the quoted company and ourselves. [If we are not

> comfortable that the auditors are appropriately skilled or experienced to act on the transaction], we may ask for a different office to be involved or a separate audit firm. Again we would expect, at first instance, a Big 4 firm to act as they have proven geographical reach, technical expertise, and sector expertise. In practice, they are also typically seen as carrying a hallmark of quality.

20. The same bank also noted that the financial position of the accountancy firm could be important and that typically the Big 4 were seen as being financially stable and of significant means.

21. Another investment bank ([✂]) said that it would advise larger companies (eg those with a market capitalization of £100 million or more) to use a Big 4 firm, on the basis that the reputation of the auditor added to the company's credibility as a public company and was a sign of intent. However, it noted that most of the IPOs that it conducted were for small and mid-cap companies listing on AIM. In these cases it said that the cost of engaging a Big 4 firm could be prohibitive and that this view was normally shared by the company and its prospective shareholders.

22. An investment bank ([✂]) said that it was concerned to see that client companies were audited by a suitable audit firm, and that generally this meant a top ten firm, not necessarily a top four firm. However, it went on to say:

> the only time we would be concerned to see a Top 4 firm, rather than a top 10, would be for larger clients or those with overseas operations, where the audit firm's physical or geographical reach would be relevant. The identity of the auditor is important. Investors expect to see a recognizable name and one that is commensurate with the company's size and spread of operations.

23. An investment bank ([✂]) said it would not normally recommend a switch to a Big 4 audit firm where an issuer had already engaged an auditor with relevant experience and expertise and had the necessary resources to perform its scope of work. However, the bank went on to say that UK-based issuers typically started preparing to become a public company well before engaging a bank as underwriter; perhaps 12 to 24 months prior to an IPO. Such preparations would include instructing an accountant to assess the issuer's readiness to become a public company, and this would require relevant experience (including geographical and sector expertise and working knowledge of the prospectus and listing requirements of the UK Listing Authority and the US Statements on Auditing Standards), as well as the necessary resources and licenses to practice in all relevant jurisdictions. 'For this reason, based on their resources, geographical coverage, sector expertise and experience advising on such transactions, issuers will typically engage one of the Big 4 audit firms (or, occasionally GT, BT or BDO) prior to the start of the IPO process.'

24. Other banks were less concerned by the use of auditors immediately outside of the Big 4 firms such as BDO and GT.

25. One investment bank ([✂]) said that if a company already had a 'Tier 2' audit firm such as BDO or GT there would be little point in suggesting a switch, although it would obviously cause concern if the auditors were a firm that no one had heard of.

26. Another investment bank ([✂]) indicated that 'in a couple of instances' it had not recommended a switch to a Big 4 audit firm because either the company already used a Big 4 audit firm, or 'a well regarded UK firm, eg Grant Thornton' had already been appointed.

27. Another investment bank ([✂]) said that in the main market listings that it had completed as lead manager, there had been one case in which the company used a non-Big-4 auditor. In this case the audit firm was GT and the bank made no recommendation to switch.

Private equity firms

28. One private equity firm ([✂]) said that it would expect the businesses it owned to be audited by one of the Big 4 audit firms and would be likely to recommend this were it to acquire a business not already audited by a Big 4 firm. It cited several reasons for this: *(a)* it already had extensive historic and current relationships with certain of these firms and was comfortable with the depth of service ability and resourcing that these firms offered, and the breadth which they could provide across geographies and industries; *(b)* it was to some extent able to use its bargaining position to negotiate fee rates; and *(c)* it typically invested in large or complex businesses, or in international transactions, requiring a breadth or depth of services which large firms were better able to provide.

29. One private equity firm ([✂]) said that it generally preferred to work with one of the Big 4 firms because of the perceived high quality of staff and their technical skills and broad range of other services. It noted that this was often a requirement of senior lending banks which were an integral part of the financing arrangements. It cited two recent transactions where it had switched the audit firm from a small- or medium-sized audit firm to a Big 4 firm.

30. One private equity firm ([✂]) said that it had 'not always' recommended a switch to a Big 4 audit firm. However, it noted that it was normal to have a review following a private equity investment and that its investment documents might state that a company should switch to a Big 4 or one of the other top 10 firms depending on the

size of the company and its complexities. It said that the second-tier audit firms were usually as capable at providing auditing services as the Big 4, given the size of the companies that the private equity firm invested in. However, factors such as 'understanding of the business, possible private equity and international complexities' might sway the decision as to whether to appoint a Big 4 firm.

31. One private equity firm ([✂]) said that it did not require its companies to use a Big 4 auditor but noted: 'We often see pressure to appoint Big 4 auditors as it appears to give more reassurance to shareholders.'

32. One private equity firm ([✂]) said that it did not keep a record of whether it had recommended a switch from a non-Big-4 firm to a Big 4 firm. It said that it generally made a switch when it made an acquisition, because it wanted a 'fresh pair of eyes', but the switch could be to any number of firms including non-Big-4 firms such as GT and BDO.

33. A private equity firm ([✂]) said that in many cases the companies that it invested in already had Big 4 auditors. It said that the reason for this was the size of the companies (mostly in the €100 million to €1 billion enterprise value range) and the fact that most were international 'so need to be serviced by an audit firm with good global reach'. However, its bank indicated that a portfolio company might need to change auditor if there were warranties in the Sale and Purchase Agreement to that effect to ensure a clean review of the accounts.

34. A private equity firm ([✂]) said that it would normally recommend the Big 4 firms plus BDO.

35. A private equity firm ([✂]) said that it was very comfortable with companies that it acquired continuing to use firms such as BDO and GT.

Criteria for assessing suitability

36. An investment bank ([✂]) said it would be concerned that the auditor was suitable according to the following criteria: *(a)* independence; *(b)* practical ability to carry out the work to a high standard; and *(c)* ability to provide appropriate backing for comfort letters and reports. It said that in relation to independence, for UK IPOs auditors were asked to prepare due diligence work (eg working capital modelling) and it was very important that the reporting accountant felt able to challenge the views of its corporate client during the due diligence work. With respect to practical ability, the bank said that it was important that the reporting accountant had the strength and depth of experienced personnel to assist in IPO work. Typically the accounting function of an IPO candidate would be stretched by the transaction, meaning that it may rely heavily on its external accountants. On *(c)*, if the IPO was being marketed to overseas investors (eg in the USA) then the banks would likely require specific international comfort letters from the reporting accountants (eg SAS72 or similar). As the potential litigation risks from an IPO could be significant, the underwriters and book-runners would prefer the providers of such comfort letters to be accustomed to delivering such letters and for them to be of appropriate financial standing.

37. One investment bank ([✂]) named auditor size, experience of main market deals, and client base, as relevant criteria for its assessment of suitability.

38. An investment bank ([✂]) said that criteria for assessing suitability of an audit firm included reputation and capabilities of the firm generally, and on a case-by-case basis, the firm's reputation and expertise in a particular area or industry, its international capabilities and network, the number of key personnel, their level of

experience, and how quickly they could be deployed. It also noted that the type of transaction may influence the choice, eg an offering comprising a placement of equity securities in the USA would require delivery of SAS72 comfort letters.

39. Another investment bank ([✂]) said that it looked for experience of the sector, history with the company, and the ability of the auditor to render both UK- and US-style comfort packages (if looking to offer the IPO to institutions in the USA). If the company had operations in other parts of the world, it would consider the size and nature of the firm's international network.

Services required from the audit firm

40. One investment bank ([✂]) said that for UK IPOs, it would typically expect the issuer to have a reporting accountant (often the auditor) who would provide various reports to the company and sponsor (working capital, long form (due diligence) report, financial reporting procedures report), as well as various comfort letters. A prospectus for a company that was listing on the London market would typically have three years of financial statements with either an Auditor's report or an Accountant's report as required by the UK Listing Authority.

41. Another investment bank ([✂]) said that in addition to the above items, it would also expect the audit firm to participate in process planning, drafting and due diligence meetings as part of the overall IPO process.

Report on Auditor Clauses in Loan Agreements

Prepared for the Competition Commission by

Dr Richard Baylis
Cardiff Business School
Cardiff University
Aberconway Building
Colum Drive
Cardiff
CF10 3EU
BaylisRM@cardiff.ac.uk

Professor Mark Clatworthy
Cardiff Business School
Cardiff University
Aberconway Building
Colum Drive
Cardiff
CF10 3EU
ClatworthyMA@cardiff.ac.uk

Professor Christopher Pong
Nottingham University Business School
University of Nottingham
Nottingham
NG8 1BB
Chris.Pong@nottingham.ac.uk

Executive Summary

1. This report was commissioned as part of the Competition Commission's inquiry into the Statutory Audit Services Market amid claims that clauses in corporate loan agreements requiring borrowers to have their financial statements audited by one of the Big 4 audit firms (Big 4 clauses) potentially represent a barrier to entry for non-Big 4 firms. Research being conducted by the authors into US corporate lending agreements (where data are publicly disclosed) revealed that some form of auditor clause appeared in virtually all lending agreements, and around half of these were clauses specifying that the borrower use a Big 4 firm (though usually with a residual element to the clause stating another nationally recognised firm could be used).

2. In order to examine the situation in the UK, the Competition Commission conducted a survey of major participants in the market for syndicated loans (i.e. lenders, the Loan Market Association [LMA], and solicitors) to assess the prevalence, nature and significance of Big 4 clauses. Responses were received from ten banks, eleven law firms, and the LMA. In addition, the Competition Commission asked the three main ratings agencies about the extent to which audited accounts and auditors' identity influence the ratings they supply.

3. The main findings from the survey were that the documentation/templates provided by the LMA represent a widespread basis for corporate lending agreements. This finding is supported by the responses from banks, solicitors and the LMA itself. Importantly, of the two main sets of LMA documentation, only one – the Leveraged Loan documentation - contains a Big 4 clause. In this clause, which is optional but often remains intact, auditors are *defined* as one of the Big 4 firms. There were, however, examples of names of non-Big 4 auditors being added to the clause. The LMA Investment Grade documentation contains no such clause. The main reasons for this clause centre around the expectation of lenders and borrowers that the LMA

documentation will be used, the familiarity of the Big 4 to international lenders (who often participate in syndicated loans) and the importance of high quality audit of financial covenants in high leverage transactions.

4. What is unclear from the responses is precisely when the Leveraged Loan documentation will be used. Some responses suggest it is used for high leverage transactions and for sub-Investment Grade loans, while others suggest it will only be used for high leverage loans. If this documentation is used for companies with sub-Investment Grade ratings, the ratings agencies' responses imply that this could affect a non-trivial proportion (at least 17) of the FTSE 350. This is a conservative estimate, since companies with no rating are more likely to be sub-Investment grade. The available data suggest that US agreements may have Big 4 clauses in them, even for Investment Grade loans/borrowers.

1. Introduction and Background

5. The presence of clauses in debt contracts requiring borrowers to have their financial statements audited by one of the Big 4 auditors (i.e., Deloitte, Ernst and Young, KPMG and PwC) has attracted the attention of numerous bodies concerned with competition in the statutory audit services market, including the House of Lords Economic Affairs Committee and the Office of Fair Trading. Such clauses have been alleged to be anti-competitive since they may restrict companies' ability to choose non-Big 4 auditors and may represent a barrier to entry to important audit markets for non-Big 4 audit firms. As shown in the Competition Commission Issues Statement, they have also led to a perception that some lenders will only consider extending credit to companies having their financial statements audited by one of the Big 4.

6. Although there is widespread anecdotal evidence on these clauses and on the potentially harmful consequences that flow from them, to date, there has been a lack of reliable evidence on the nature of the clauses, on how often they occur and on the conditions under which they are most likely to appear.[4] Prompted by the regulatory interest in these clauses and the significance of the corporate debt market, the authors of this report commenced a research project involving a systematic analysis of corporate lending agreements and a detailed examination of auditor clauses. However, UK companies are not required to disclose lending agreements, so data were collected for a sample of US firms (these agreements are filed with the Securities and Exchange Commission and are thus made publicly available). As reported by Sufi (2007), the syndicated loan market represents a primary source of finance for most large companies: almost 90% of the largest US industrial companies obtained syndicated loan finance between 1994 and 2002. Saunders and Steffen (2011) provide statistics demonstrating that the UK syndicated loan market is also highly active for both public and private companies and the Bank of England (2012)

[4] For instance, Hinks (2011) compares such clauses with the Loch Ness Monster – 'much talked about but never proven'.

estimates gross syndicated lending to UK non-financial companies in 2011 to be almost £100 billion.

7. There are some suggestions in the academic literature that debt providers are concerned by the identity and/or quality of borrowers' auditors. Pittman and Fortin (2004) found, based on a sample of 371 newly public US firms, that the cost of debt capital is lower if the firm appoints a (then) Big 6 auditor. This effect was, however, found to subside over time and to be most pronounced for younger firms, for which less financial information is available. Furthermore, this study relied on a 'noisy' measure of the cost of debt estimated from interest payments in the financial statements, rather than directly on lending agreements. Mansi et al. (2004) also find that bond yields are lower for US firms employing a Big 6 auditor, and this effect is larger for non-Investment Grade firms.

8. A preliminary analysis by the authors of 44 US lending agreements suggested that Big 4 clauses were widespread, but in many cases, the auditor in the clause was the incumbent. In addition, some clauses also referred to mid-tier audit firms. More recent and more comprehensive analysis (discussed in more detail below) revealed that virtually all contracts examined had some form of auditor identity clause and in around 50% of cases, this either specifically or generically referred to a Big 4 auditor. The remainder were clauses referring to 'nationally recognised' auditors. The analysis of US data also revealed that there are many UK banks participating in the US market as international syndicate members.

9. It is possible, however, that US-based results are not representative of the UK market, so to examine these issues in the context of the UK loan market, the Competition Commission administered a survey of key market participants, namely UK lenders (i.e., banks), the European trade association for syndicated loans (the

Loan Market Association [LMA]), credit ratings agencies and solicitors. The combined survey responses produced considerable evidence that standard documentation provided by the LMA is largely responsible for contract design and since some of the templates (those for sub-investment grade or leveraged loans) contain clauses defining auditors as one of the Big 4, it seems unsurprising that they persist across a significant number of agreements. What is unclear is how pervasive they are for FTSE 350 companies, since there is ambiguity about when an agreement will be based on documentation which initially includes a Big 4 clause.

10. The remainder of the report sets out the evidence from the authors' ongoing investigation of the US syndicated loan market, and then presents the main results from the CC survey of banks, the LMA, ratings agencies and solicitors. It concludes with a brief discussion of the evidence overall and identifies potential areas where more evidence might be beneficial.

2. Evidence from US syndicated Loan Agreements

11. Since the initial response to the Issues Statement, the authors have extended the analysis of US firms to a larger sample to produce a more informed and reliable response. In particular, 232 contracts for 2008 and 2010 have now been examined and a summary of the main results is presented in Table 1. It is evident that syndicated loan agreements relate to very large transactions. In 2010, the average size of loan/facility is $686 million, with the largest being in excess of $7 billion.

Table 1
Descriptive Statistics for US Sample

	2010	2008
Sample	n = 143	n = 89
Total borrowing of sample	$98 billion	$41 billion
Average contract value	$686 million	$460 million
Largest contract value	$7.2 billion	$5 billion
Smallest contract value	$5 million	$1 million

12. While the situation in the US may not be identical to the UK, a significant proportion of the contracts (over 30% in 2010, as noted in Table 2 below) involve UK banks as participants in the loan syndicates (though these data were not available for the full sample).

Table 2 Frequency of UK Lenders participating within US led Syndicates		
	2010 (n = 135)	2008 (n = 88)
Number of contracts where a UK Lender was a member of the Loan Syndicate	50 (37.0%)	24 (27.3%)

13. To assess the prevalence of and nature of auditor clauses, each lending agreement was reviewed to identify whether any clause was present. From this review, 3 types were identified:

Big 4 – The clause will either specifically or generically require an Auditor considered to be one of the Big 4 Auditors, as illustrated below:

Bill Barrett Corporation

"reported on by Deloitte & Touche LLP or other independent public accountants of recognized national standing"

McAfee Inc.

"audited and accompanied by a report and opinion of a "Big Four" accounting firm or another independent certified public accountant of nationally recognized standing reasonably acceptable to the Required Lenders"

Non-Big 4 – The clause will detail a specific auditor, but one named outside of the Big 4:

Global Geophysical Services Inc.

"audited and accompanied by a report and opinion of UHY, LLC or another independent certified public accountant of nationally recognized standing reasonably acceptable to the Administrative Agent"

Nationally recognised – The only requirement is that the Auditor is of a national standard:

Baker Hughes Inc.

"audited by independent certified public accountants of recognized national standing reasonably acceptable to the Lenders"

14. As reported in Table 3, of the US contracts reviewed, over 95% contained a clause covering the identity of borrowers' auditors, whether specific or general. Of the overall sample, more than 50% required a Big 4 auditor, compared with only 3% requiring one outside of the Big 4 group. Even though the remaining population (approximately 40%) did not require a specific auditor, the level of clauses requiring a Big 4 auditor is significant.

Table 3
Frequency of Clauses Referring to Specific Auditors in US Agreements

	2010 (n = 143)	2008 (n = 89)
Number of contracts where an auditor clause was in place	136 (95.1%)	87 (97.8%)
Number of contracts where an auditor clause was in place requiring either a specific or generic 'Big 4' auditor	75 (52.4%)	47 (52.8%)
Number of contracts where an auditor clause was in place requiring a 'non Big 4' auditor	5 (3.5%)	3 (3.4%)
Number of contracts where an auditor clause was in place requiring a 'nationally recognised' auditor	56 (39.2%)	37 (41.6%)

As acknowledged above, however, the US-based results might not be representative of the UK market.

3. Evidence from Competition Commission Survey

15. In order to assess the position in the UK, the Competition Commission sent out questionnaires to major participants in the UK syndicated loan market, namely the LMA, lenders (banks), ratings agencies and legal advisors (solicitors).

3.1 Sample

16. Consistent with the US analysis, the focus of the investigation was syndicated loan agreements. In the case of the banks surveyed (representing lenders), Bloomberg was used to identify the top providers of syndicated loan finance to UK and Irish companies between 2009 and 2011, and the largest ten of these organisations (understood to represent approximately 63 per cent of the total value of syndicated loans originating during that period) formed the basis for the sample. The banks so identified are set out in Table 4 below. Responses were received from all ten banks.

17. Information was requested from legal advisors of syndicated loan providers likely to advise on the drafting and content of loan agreements. The Legal 500 was used to identify the top advisors for investment grade debt and syndicated loans. This included 11 firms and all were written to. A response was received from all of these firms. In addition, the Loan Market Association – the trade association for participants in the syndicated loan sector – was written to.

18. Finally, information was sought from the three major rating agencies: Fitch Ratings Ltd; Moody's Investors Service Ltd; and Standard & Poor's Financial Services LLC. Each was asked about which companies in the FTSE 350 they provide ratings for and the extent to which audited accounts and auditors' identity influence the ratings they supply. All three provided responses. A summary of those contacted in the survey is provided in Table 4 below.

Table 4 Market Participants Contacted by the Competition Commission†		
Banks Contacted	Legal Advisors Contacted	Ratings Agencies Contacted
RBS	Allen & Overy LLP	Fitch Ratings
Barclays Bank plc	Clifford Chance LLP	Moody's
Lloyds Bank, Wholesale Banking & Markets	Linklaters LLP	Standard & Poor's
HSBC Bank PLC	Freshfields Bruckhaus Deringer LLP	
BNP Paribas Group	Herbert Smith LLP	
JP Morgan Chase	Slaughter and May	
Citi	White and Case LLP	
Société Générale, London Branch	CMS Cameron McKenna LLP	
Deutsche Bank, London Branch	Hogan Lovells International LLP	
Crédit Agricole Corporate and Investment Bank London Branch	SNR Denton	
	Norton Rose LLP	
Every organisation contacted provided a response.		

3.2 Responses to the Competition Commission Survey

3.2.1 The Loan Market Association (LMA)

19. The LMA was established in 1996 with the key objective of improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa. Its members include a wide range of lenders and law firms, as well as other market participants such as ratings agencies and service providers.. In order to aid efficiency in the contracting process, the LMA produces standardised documentation designed to form the basis of lending agreements for syndicated loans. This is an important function since these documents are often lengthy, complex and (as shown above) relate to highly significant economic transactions. Although, according to the LMA, the documentation is designed to reflect 'market practice', they point out in their response that 'all LMA recommended forms are a starting point only and are subject to negotiation on a deal by deal basis'.

20. A major finding from the CC survey is that some of the documents produced by the LMA include a clause defining the term 'auditors' for the purpose of the loan. This

clause, however, is only present in the documentation for 'Leveraged' loans and not in the 'Investment Grade' documentation.

21. The LMA Leveraged auditor clause states:

'Auditors means [one of PricewaterhouseCoopers, Ernst & Young, KPMG or Deloitte & Touche] or any other firm approved in advance by the Majority Lenders (such approval not to be reasonably withheld or delayed).'

When asked for the reasons for inserting such clauses, the LMA responded: '*The clauses that are included in LMA documentation in relation to the borrower's auditors reflect market practice. They are the provisions that lenders commonly require and, in the case of the Investment Grade Facility Agreement, that borrowers are willing to accept*.'

The square brackets in the clause are significant because the LMA states its documents are a starting point only and subject to negotiation; furthermore, where something appears in square brackets, this is an indication that the text included is a suggestion. The LMA states in its response '*It is made clear in the Users' Guides that not including something in square brackets is not to be considered as a departure from the LMA form*.' The sample of clauses provided by the banks [below] suggests that although it is a 'default' clause subject to routine removal, it remains prevalent in Leveraged loan transactions.

22. An important issue determining the presence of Big 4 clauses is therefore which of the sets of LMA documentation is used: Investment Grade or Leveraged. Some evidence (including that contained in evidence from the banks) suggests that companies with ratings below BBB- are treated as 'Leveraged' and thus will have such clauses in their lending agreements (see eg the response of [✂][5]). A briefing

[5] Although this bank said that the policy is not invariably applied in all "leveraged" loan facilities: it will consider each case on its merits, taking into account any representations made by borrowers in the course of negotiations, which could lead to the auditor clauses being modified or even removed altogether in appropriate cases.

document provided for the CC by an advisor with working experience of this sector (Annex 1), however, states that the Investment Grade documentation will usually be the starting point for FTSE 350 companies and provisions will be included from the Leveraged documentation only when credit quality is low. It is asserted in this briefing document (though without supporting evidence) that the auditor clause is less likely to be amended since it is not perceived as contentious or restrictive in practice because the company has no intention or wish to use an auditor that was not previously permitted. Evidence from one of the law firms also supports this view. Freshfield Bruckhaus Deringer noted: '*It is also usually the case that the auditors used by the borrower at the time the facilities are entered into are taken into consideration and if the existing auditors are acceptable to the syndicate of banks, they are included in the definition of "Auditors"*'.

Key Findings:

23. **LMA documentation is widely used as the basis for lending agreements and of the two main types (Investment Grade and Leveraged), only the Leveraged documentation contains a clause defining auditors as one of the Big 4 auditors.**

24. **This clause is inserted in a way that makes it easy to amend/remove, but other evidence (below) suggests it is often left as it is.**

25. **Though most FTSE 350 companies are likely to have lending agreements based on Investment Grade documentation, it is not clear exactly when a syndicated loan agreement will be based on Leveraged documents or Investment Grade documents.**

3.2.2 Banks

26. Banks were asked a number of questions concerning the nature and prevalence of auditor clauses inserted into lending agreements and the reasons for inserting them (where relevant). Banks' responses indicated that auditor clauses are commonly inserted into their lending agreements, though this is attributable to the widespread use of the LMA documentation and therefore typically occurs only where the borrower is not considered of Investment Grade.

27. As Table 5 shows, the vast majority of the nine banks responding stated that they relied initially on the LMA documentation and provided extracts from the agreements with some reference to the type of auditor used by the borrower (either as a Big 4 auditor or as an internationally recognised auditor).

Table 5 Reliance of Banks on LMA Documentation (n = 10)	
Stated Reliance on LMA Documents	Did not State Reliance on LMA Documentation
8	2

28. Importantly, however, even the two banks that did not explicitly state they relied on LMA documentation did refer to these documents in their responses to the survey and it was implicit that they would be relied upon in some agreements. One bank ([✂]) noted that auditor clauses may be inserted for leveraged acquisition finance transactions because they are included in the LMA precedent loan agreement. [✂] reproduced an auditor clause identical to the one contained in the LMA leveraged finance loan documentation, as an example of the type of auditor clause it used in many syndicated loan agreements with leveraged finance borrowers (which were not 'large corporates').

29. The banks' responses indicate that it is rare for a lender to require a borrower to change auditor because of a contractual clause (see Table 6 below). Lenders did not

envisage circumstances where the clause would require a change in auditor (one commented that this would take place before the agreement was drawn up). One bank ([✂]) did note that in states outside the EEA where best practices may not conform to international accounting standards, participating banks may require the use of "international auditors" , but this is not relevant for the FTSE 350 companies that are the main focus of the CC's current investigation. HSBC noted that in its experience, borrowers entering into large leveraged financed transactions will typically already have appointed one of PwC, KPMG, Deloitte or E&Y in any event. It said that where highly leveraged transactions were entered into by mid-market borrowers, it was common for HSBC to accept a wider definition of auditor (e.g. at the request of the borrower).

Table 6 How Often do Clauses Require Borrower to Switch Auditor (n = 10)	
Do not Typically Require Borrower to Change Auditor	Did not Respond to Question Directly
9	1

30. When asked about differences in the clauses used in lending agreements and the circumstances under which different ones would be used, all respondents either cited the LMA templates or provided examples of different clauses of a similar nature to the LMA Leveraged Loan clause (i.e. specifying that any one of the Big 4 or another independent international accounting firm appointed with advance approval of the lender). There was not a direct response in all cases, but for some, there were clauses that cited the borrower's existing auditor. Furthermore, in the clauses provided, there were four examples of the LMA auditor clause being adapted to include auditors outside the Big 4. For instance, the clause in the loan agreement provided by Lloyds in the loan to [✂] includes the Big 4, plus Grant Thornton and BDO Stoy Hayward (in addition to the 'residual' element of the clause)[6]. It was also

[6] It also allowed for any other firm approved by the "majority lenders" to be appointed.

interesting when reviewing these clauses, however, to note an example (in the [✂] agreement) where the Big 4 auditors and firms of international standing were seemingly viewed as synonymous:

'Auditors' means Deloitte & Touche LLP or such firm of independent public accountants of international standing which is appointed with the approval in writing of Agent (which appointment is hereby given in relation to PwC, Ernst & Young and KPMG (or any amalgamation or successor of any of them) to audit the annual consolidated accounts of the Company).

31. The departure from the wording of the LMA template in this clause leaves it as an example of one that might well create a reluctance to switch out of the Big 4 (Deloitte were [✂]'s auditors at the time of the agreement).

32. Further evidence that the insertion of auditor clauses is not driven by auditors or borrowers is provided by banks' responses. As Table 7 below shows, not one bank was able to identify circumstances where a borrower or borrower's auditor asked for a clause to be inserted.

Table 7 Banks being Asked to Insert Auditor Clauses by Borrower/Auditor	
Identified Circumstances where Borrower/Borrower's Auditor asked for Auditor Clause to be Inserted	Did not Identify Circumstances where Borrower/Borrower's Auditor asked for Auditor Clause to be Inserted
0	10

33. Furthermore, there have been no changes to policy over time. As shown in Table 8, all banks responding either had seen no change over the last five years or had no policy in the first place (one bank – Citi – requires financial statements to be prepared by an independent auditor but did not have a policy relating to the identity of the auditor).

Table 8 Changes in Banks' Policy on Auditor Clauses	
Stated Change in Policy on Auditor Clauses in the Last Five Years	Stated No Change in Policy on Auditor Clauses in the Last Five Years or Has no Policy
0	10

34. An additional finding from the banks is that although they not the subject of this research, bilateral loan agreements either do not contain auditor clauses or the same practice was used as for syndicated loans, as Table 9 reveals.

Table 9 Banks' Use of Auditor Clauses in Bilateral Loan Agreements		
Agreements do not Contain Auditor Clause	Same as Syndicated Loans	No Response
4	5	1

Key Findings:

35. **Banks rely heavily on LMA documentation, so auditor clauses are typically confined to Leveraged Loans/sub-Investment Grade loans and are not requested by borrowers or their auditors.**

36. **Where auditor clauses are used, they do not typically require borrowers to change auditors.**

37. **Bilateral agreements are often similar to syndicated loan agreements with respect to auditor clauses.**

38. **Banks' policies on auditor clauses have not changed over the last five years.**

3.2.3 Solicitors

39. The results from the solicitors very clearly confirmed the widespread use of the LMA templates. There was universal acknowledgement that Leveraged Loans would

typically contain an auditor clause, and this was attributed to the use of the LMA documentation for these transactions. Law firms involved in the syndicated loan market were asked whether they used a template as a basis for their syndicated loan agreements (subject to modification), if so, whether any clauses related to borrowers' auditors were included and the reasons for including any such clauses. As reported in Table 10 below, all firms used a template based to some degree and further analysis showed that this was invariably the LMA documentation.

Table 10 Solicitors' Responses on Templates and Auditor Clauses (n = 11)		
	Yes	No
Used template for syndicated loans	11	0
Inserted auditor clauses in last 5 years (for any grade of debt)	10	1

40. Norton Rose confirmed that it used LMA documentation in line with market practice and although this documentation did not generally contain any provisions relating to the borrower's choice of auditor, one exception was identified: the LMA standard form leveraged finance multicurrency syndicated loan agreement. Such loans are considered to be "sub-investment grade loans" requiring higher levels of protection against risk by lenders compared with other types of syndicated loans. One firm ([✂]) indicated that the Leveraged documentation would be used for high-leverage transactions (and even for some sub-Investment Grade loans, the CC briefing document suggests that the Investment Grade documents would probably be used for FTSE 350 companies, perhaps with some tighter restrictions than the standard template). In addition, one firm (Freshfields Bruckhaus Deringer) reported that it adds the name of the borrower's existing auditors to the template (subject to such auditors being acceptable in the opinion of the lenders).

41. When asked about the reasons for including such clauses, several firms cited the fact that the LMA reflected market practice and thus what both lenders and borrowers expect to see (similar to the response of the LMA itself). The efficiency involved in using the LMA documentation, the familiarity of the named auditors to lenders (which are often international, as shown in the US analysis) and the importance of audit quality for the financial covenants in the agreements in leveraged transactions were also cited as reasons for their inclusion.

42. A useful feature of this part of the survey was that solicitors were asked about the extent to which their practice with syndicated loan agreements reflected what they did with bilateral loans. It was noted (as it was by the LMA) that the LMA does not produce documentation for bilateral loans, yet there was strong evidence that the practice was very similar. Although three firms reported that bilateral loan agreements did not contain auditor identity clauses, seven of the eleven reported that they used the same approach as for syndicated loans.

Key Findings:

43. **The LMA documentation was relied upon as a basis for negotiating syndicated loans by all law firms surveyed, so the Leveraged documentation is likely to contain auditor clauses.**

44. **The reasons for including auditor clauses mainly include reflecting market practice, offering familiarity to (often international) lenders and ensuring high quality of audit of financial covenants.**

45. **The practice for bilateral loans seems similar to that for syndicated loans, so it is likely that auditor clauses do not appear in Investment Grade documentation and may appear in Leveraged agreements.**

3.2.4 Ratings Agencies

46. The Competition Commission survey obtained valuable information from the three main credit ratings agencies: Fitch, Moody's and Standard and Poor's (S&P). Each was asked about which companies in the FTSE 350 they provide ratings for and the extent to which audited accounts and auditors' identity influence the ratings they supply. These questions were not asked in the context of clauses in loan agreements, and they were not asked to comment on such clauses in particular. The agencies stated that they use information in the audited accounts and the additional documentation provided by the agencies indicated that such information is crucial. Moody's said that information in the audited accounts was important, but was not the only source of information in its rating process.

47. S&P supply ratings for 91 of the FTSE 350 (but did not, in their reply, report which ones). Their Analytical Methodology document states that they rely on companies' audited financial statements and 'the inherent checks and balances in the financial reporting process', but S&P also stated that '*The identity of a company's auditor has no bearing on Standard & Poor's analysis*'. S&P's Analytical Methodology notes that in the context of delays in filing financial reports, restatements of financial statements, material weaknesses in financial statements and related investigations, such issues lead to other adverse results, including among other things, auditor changes, and that the impact of which must be closely evaluated in the ratings process.

48. Responses of Fitch and Moody's, however, both indicate that auditor identity can potentially influence the credit rating decision. Moody's said that because audited accounts are an important source of information, the adequacy of resources, experience and independence of the auditor must be sufficient. In the vast majority of cases, the identity of the auditor is not a concern, but in a very small number of

cases, it has had concerns about the abilities of the chosen auditor. They also provided details of the firms in the FTSE 350 that they provide ratings for, as shown in Table 11 below.

Table 11 Responses of Ratings Agencies			
	Fitch	Moody's	Standard & Poor's
No. of ratings in FTSE 350	66	81	91
No. sub-Investment Grade	8	15	N/A
Does auditor identity affect analysis?	Yes	Yes, for minority of cases	No
Do ratings change after auditor switch	Not aware of any	Not aware of any	No

Note: Fitch data accurate as of 20 April 2012.

49. Moody's stated that audited accounts are an important information source and that EU credit rating regulation requires information used by rating agencies to be of sufficient quality and from reliable sources. Moody's noted that in a small minority of cases, the identity of the audit firm is important, since the incumbent might not be sufficiently reliable, independent or well-resourced to perform the audit role adequately. Moody's also stated that a lack of satisfaction with the auditor's level of capability and/or independence may result in withdrawal of a rating or a refusal to provide one in the first place. This is in accordance with Moody's policy that '*employees must refuse to provide a rating when there is a lack of reliable data, or the quality of information is not satisfactory or raises serious questions as to whether Moody's can provide a credible rating*' and with their policy of withdrawing ratings where the information to support the rating is insufficient to effectively assess the creditworthiness of the company or obligation.

50. It is important not to overstate the importance of this issue, since Moody's were not aware of any FTSE 350 ratings change in the last three years and it is not normally an issue for concern; however, they did point out that '*there are circumstances where*

the reliability of the audit firm could have an impact on Moody's decision to rate or maintain an existing rating.'

51. Fitch's response discussed a hypothetical case of a very small audit firm auditing a very large company to illustrate that in principle, auditor size and capability does matter, though it acknowledged the difficulty of defining procedures and policies around this issue. Fitch then noted that in practice, auditor identity would be discussed at a rating committee meeting and judgement exercised. In its rating criteria, Fitch discussed an 'asymmetry' surrounding accounting and audit integrity (as part of corporate governance issues more generally), pointing out that where they are deemed adequate or strong they have no impact, but where there are perceived deficiencies, these may result in a negative impact on ratings. Fitch's rating criteria also state that where financial statements based on either IFRS or US GAAP are not available, its choice of whether to rely on local GAAP accounts depends partly on the quality of the auditor.

52. Although the tone of the correspondence implied that auditor identity might not be a major issue in practice, in principle, it is clearly important for two of the three agencies. There is no suggestion, however, that audit firms immediately outside the Big 4 would be a cause for concern. Furthermore, the responses suggested that in itself, a change in auditor would not have much impact upon ratings (though the factors associated with the switch might).

Key Findings:

53. **Ratings agencies provide ratings for under a third of FTSE 350 companies, at least 17 of which are rated below Investment Grade (based on Fitch and Moody's data).**

54. **Auditor identity potentially affects ratings analysis for two of the three agencies.**

55. **Auditor switching *per se* seemingly has little impact on ratings.**

4. Discussion and Further Issues

56. The significance of the transactions involved in the syndicated loan market and the well-known use of financial covenants in lending agreements should make it unsurprising that lenders and ratings agencies are concerned about the size, capabilities and independence of auditors of the borrower's financial statements to some degree. It is clear from the US analysis that syndicated loan agreements routinely include clauses relating to the identity of the auditor.

57. The predominant finding of the Competition Commission's survey of participants in the syndicated loan market is the importance of the LMA documentation. It seems that the largest firms' agreements would not typically contain clauses specifying which auditors borrowers should employ.

58. Determining precisely when the Leveraged documentation is used is difficult since the definition of a leveraged syndicated loan is itself ambiguous and even where it is used synonymously with sub-investment grade loans, this does not necessarily mean that companies with sub-Investment grade ratings will have their loans based on the Leveraged documentation.

59. On the one hand, the fact that few FTSE 350 companies would have their agreement based on the Leverage documentation with an auditor clause in the agreement (though ratings agencies' responses coupled with some of the banks' responses suggested that some might) would suggest that this potential barrier to entry to the

audit market for these firms is not as serious as first thought. On the other hand, although there have been few changes in policy over the last five years, any move by the LMA to include such a clause in the Investment Grade documentation would create a systemic change, potentially making such clauses almost universal.

60. An important question is: what drives the presence/absence of these clauses in the LMA documentation in the first place. Some of the comments in the responses suggested that one of the reasons that many contracts *do not* include these clauses is because of the expectation that large listed firms would already have a Big 4 auditor. The high Big 4 concentration in the FTSE 350 therefore seems partly responsible for the absence of these clauses and it might be inferred that a lack of concentration could lead to an increase in these clauses (though this is not supported by any data).

61. For the Leveraged LMA documentation, which does contain a clause that seems to remain in many contracts (despite being optional), a possible factor is that, as found in US studies (e.g. Yago and McCarthy, 2004), pricing grids in lending agreements are often linked to accounting ratios (rather than bond ratings, which may not exist for these firms). If this is the case, in addition to the importance of the covenants discussed by the legal advisors' responses, the quality of the accounting information has direct cash flow implications for lenders, making the perceived quality of the auditor especially important.

62. The extent to which the US equivalent of the LMA includes auditor clauses in standard documentation (and the extent to which this is used by market participants) is unclear. The US equivalent of the LMA – the Loan Syndications and Trading Association (LSTA) – produces some standard documentation, though this is only available to members (or to non-members at a cost of $1000). The LSTA Credit

Agreement Guide includes a standard term stating only that the financial statements should be provided, 'all reported on by [✂] or other independent public accountants of recognized national standing', implying that the incumbent auditor is inserted. However, closer inspection of actual US lending agreements revealed that auditor clauses are not limited to sub-Investment Grade ratings for US companies. For example, an agreement for a loan to Harris Corporation[7] in 2008 (at that time rated Baa1 by Moody's) included a clause that borrowers should supply 'a report and opinion of Ernst & Young LLP, Deloitte & Touche USA LLP, PricewaterhouseCoopers LLP, KPMG LLP or another independent certified public accountant of nationally recognized standing reasonably acceptable to the Required Lenders.'

63. Despite searches of the literature and reference to modern banking and finance texts, it has not been possible to ascertain whether UK firms will be affected by these US practices because even where UK firms wish to raise finance denominated in US dollars, Eurodollar loans may be obtained in London. That is, UK firms may not necessarily come into contact with US banks and therefore US lending agreements to raise dollar denominated loan finance, even though for very large transactions, a US bank may be lead arranger for the syndicate. This issue may be worthy of further investigation with practitioners and those involved directly in the market.

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Briefing paper on the use of a definition of 'auditors' in bank loan facility agreements

Summary

1. This paper describes the type of company likely to have a loan facility that restricts its choice of auditor, focusing particularly on FTSE 350 constituents. The observations in the paper are based on a CC staff member's experience of the UK loan market from previous employment at a UK bank.

2. Loan facility agreements for investment-grade borrowers are very likely to be based on the Loan Market Association (LMA) investment-grade document, which does not contain an auditor definition. Loan facility agreements for private-equity-backed leveraged buyouts (LBOs) are very likely to be based on the LMA leveraged loan document, which does contain an auditor definition. Between these ends of the credit spectrum it is difficult to be definitive because loan terms are negotiated between a borrower and its banks. The style of loan facility agreement for FTSE 350 companies which do not have an investment-grade credit rating will be influenced by the size and creditworthiness of the company, the purpose of the loan facility and any precedent documents.

3. The auditor definition that may be contained in a loan agreement is not perceived as contentious by bankers or banking lawyers and its inclusion (or otherwise) in a loan agreement is rarely a heavily negotiated point. When an auditor definition is included banks are generally willing to expand the definition to include other firms in addition to the Big 4 if requested.

Loan Market Association template documents

4. The LMA template investment-grade loan facility agreement (the LMA investment-grade document) was developed to facilitate the negotiation of loan facility agreements for investment-grade companies. The document does not define who a borrower may use as its auditors.

5. The LMA template leveraged loan facility agreement (the LMA leveraged document) was developed to facilitate the negotiation of loan facility agreements for private-equity-backed LBOs (and not for non-investment-grade corporate lending). The document defines who a borrower may use as its auditors as follows: 'Auditors means [any one of PricewaterhouseCoopers, Ernst & Young, KPMG and Deloitte and Touche] or such other firm approved in advance by the Majority Lenders.' The reference in the above definition to 'Majority Lenders' means that approval to use an alternative auditor would need to be given by lenders whose aggregate commitments in the loan facility are at least 66⅔ per cent of the total loan commitments. In relation to private-equity-backed LBOs, the author's experience was that a request from a borrower to include other major audit firms in the definition would rarely be contentious.

6. The LMA template documents are widely used as the starting point for negotiating syndicated loan facility agreements, although there is no requirement that the LMA templates should be used. Advantages for borrowers and banks of using the templates include:

   (a) avoiding spending time drafting loan agreements from scratch;

   (b) avoiding negotiating standard 'boilerplate' clauses; and

   (c) giving confidence to underwriting banks that the form of the loan agreement (but not necessarily to commercial terms) will be acceptable to banks looking to participate in the loan syndication.

7. The LMA working group which drafted the LMA investment-grade document included banks, lawyers and the Association of Corporate Treasurers (ACT) which represented borrowers' interests. As a consequence of the ACT's involvement, the LMA investment-grade document is considered to be generally acceptable to banks and borrowers.

8. The LMA working group which drafted the LMA leveraged document had no representation on behalf of borrowers because private equity firms tend to prefer to negotiate their own deals. As a consequence the LMA leveraged document does not have the same degree of 'buy-in' from borrowers as the LMA investment-grade document. While the template is widely used as a starting point, leveraged loan agreements are generally more heavily negotiated than investment-grade loan facilities.

Loan agreements for FTSE 350 companies

How widely used are syndicated loans?

9. Most companies in the FTSE 350 or with loan facilities in excess of £30 million, borrow in the syndicated loan market or have club facilities. Club facilities are small syndicates comprised mainly of relationship banks. These arrangements are preferred to bilateral facilities because:

   (a) the loan exposure is divided between a number of banks;

   (b) banks do not want excessive exposure to a single borrower;

   (c) borrowers are more aware (post-Lehman) that a bank may default and that there is a risk in having only one banking relationship;

   (d) borrowings are on common terms and are therefore easier for a borrower to manage; and,

   (e) there is less administration for the borrower as the agent bank handles payments to and from the banks and distributes financial information to the lenders.

Investment-grade document or leveraged document?

10. There are 67 companies in the FTSE 350 that have an S&P investment-grade credit rating.[8] Loan facility agreements for these companies are very likely to be based on the LMA investment-grade document, which does not contain an auditor definition.

11. There are 13 companies in the FTSE 350 that have an S&P sub-investment-grade credit rating[9].

12. The author's view is that the main factors that determine whether a non-investment-grade FTSE 350 company is likely to have a loan agreement based more on the LMA investment-grade document or on the LMA leveraged document, are as follows:

    (a) For FTSE 350 companies, the starting point for loan documentation is likely to be the LMA investment-grade document. As noted in paragraph 5, the LMA leveraged document was developed for private-equity-backed LBOs, not for listed companies. For those companies whose credit quality is considered to be weak, or when a company's financial leverage is rising because it is increasing its borrowings to finance a sizable acquisition, banks may base the loan agreement on the LMA investment-grade document but include some provisions from the LMA leveraged document. Such provisions would probably relate to credit matters, for example, financial covenants, other undertakings (such as restrictions on acquisitions or disposal of assets) and information reporting. It is less likely that the auditor definition would be included in the loan agreement in these circumstances as a FTSE 350 company is likely already to be using a Big 4 firm.

    (b) An exception to using the LMA investment-grade document might occur when the company has been a private equity backed LBO that has undertaken an initial

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[8] Source: Bloomberg.
[9] Source: Bloomberg.

public offering (IPO) and still has relatively high financial leverage. In these circumstances, the loan facilities may be based on the precedent leveraged loan agreements from pre-IPO, or the banks may pre-agree certain amendments that will become effective upon the IPO occurring. The focus in these cases is usually on pricing (the interest margin), the frequency of the financial reporting requirements and credit-related matters. The auditor definition is less likely to be amended because it is not perceived as contentious or restrictive in practice, because the company has no intention or wish to use an auditor that was not previously permitted.

13. Corporate banking tends to distinguish between 'large' companies and 'mid-market' companies:[10]

- For large companies,[11] the starting point for loan facility agreements will be the LMA investment-grade document.
- For mid-market companies,[12] the more creditworthy companies (which have modest leverage and a stable business) are likely to use the LMA investment-grade document. The loan facility agreements for unlisted and more highly financially leveraged companies may be based on the LMA leveraged document, especially when the loan facilities are being put in place for a significant acquisition. The author estimates that roughly half of mid-market borrowers have loan facility agreements that contain an auditor definition. The author's view is that a request from a company to include other major audit firms in the definition of auditors would rarely be contentious. Expanding the definition to permit 'auditors of international standing and repute' is also unlikely to be a problem.

[10] These terms do not have precise definitions and how they are applied will depend on each bank's market segmentation.
[11] Large companies are assumed here to be listed companies with turnover in excess of £1 billion.
[12] Mid-market companies are assumed here to be listed and unlisted companies with turnover in the range of £250 million to £1 billion and borrowings in the range of £30 million to £750 million.

Law and regulation applicable to the provision of statutory audit services

Contents

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Introduction

1. This appendix sets out the CC's understanding of the law and regulation as at 1 February 2013 applicable to the provision of statutory audit services in the UK under five headings, as follows:

   (a) the duty to keep records and prepare reports;

   (b) the statutory and common law regarding the provision of statutory audit services;

   (c) the regulation applicable to the contents and quality of a statutory audit;

   (d) the institutions relevant to and tasked with the enforcement of the standards applicable to audit quality and to auditor quality and independence;

   (e) the role of ACs; and

   (f) the role of shareholders with regard to audits.

2. The UK regulatory framework is determined by UK and EU legislation and regulation, and by financial reporting standards issued by UK and international accounting standards boards, in addition to the auditing and ethical standards of the Audit and Assurance Council (formerly the Auditing Practices Board—APB) of the FRC. Audits

of Public Interest Entities (PIE)[1], which include FTSE 350 companies, need also to comply with international reporting requirements, including the IESBA Code (International Ethics Standards Board for Accountants) issued by IFAC (International Federation of Accountants).

The duty to keep records and prepare reports

3. General duties that the directors owe to a company are specified in the Companies Act.[2] These are based on (and replace) common law rules and equitable principles as they apply to directors and are to be interpreted and applied in the same way as those rules and principles.[3] These general duties include a duty to promote the success of the company[4] and the duty to exercise reasonable care, skill and diligence.[5]

4. Companies have a duty to keep accounting records which disclose with reasonable accuracy at any time the financial position of the company at that time.[6] These records must contain entries of all sums of money received and expended by the company, a record of the assets and liabilities of the company and statements of any stock held by the company at the end of each financial year.[7] The accounts must also be sufficient to enable the directors to ensure that any accounts required to be prepared comply with the requirements of the Companies Act and, where applicable, of Article 4 of the IAS Regulation.[8]

5. The directors of a company (including an unregistered company) must not approve accounts unless they are satisfied that they give a true and fair view of the assets,

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[1] PIE, broadly, are entities such as credit institutions, insurance companies and investment firms which are of significant public interest because of their business, size, number of employees or their corporate status.
[2] Sections 171–177 of the Companies Act.
[3] Section 170(3) & (4) of the Companies Act.
[4] Section 172 of the Companies Act.
[5] Section 174 of the Companies Act.
[6] Section 386(2)(b) of the Companies Act.
[7] Section 386(3) of the Companies Act.
[8] Section 386(2)(c) of the Companies Act. The IAS Regulation is EC Regulation No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

liabilities, financial position and profit or loss of the company, or (in the case of group accounts) of the undertakings included in the consolidation as a whole, so far as concerns members of the company.[9] See further paragraphs 58 to 61 for discussion of the meaning of 'true and fair'.

6. A company's annual accounts must be approved by the board of directors and signed on behalf of the board by a director.[10] Any director who approved annual accounts, knowing that they did not comply with the requirements of the Companies Act and, where applicable, of Article 4 of the IAS Regulation, or being reckless as to whether they complied, and who failed to take reasonable steps to secure compliance or prevent the accounts from being approved, commits a criminal offence, punishable by a fine.[11]

7. The directors of a company have a duty to prepare a directors' report for each financial year.[12] Unless a company is exempt from the requirement for the accounts to be audited, the directors' report for each financial year must include a statement as to disclosure to auditors. This statement must be to the effect that, in the case of each of the persons who were directors at the time the report was approved, so far as each was aware, there was no relevant audit information of which the company's auditor was unaware; and each had taken all the steps that ought to have been taken as a director in order to become aware of any relevant audit information and to establish that the company's auditor was aware of that information.[13] This would include making such enquiries of fellow directors and of the auditors, and such other steps as was required by the duty to exercise reasonable care, skill and diligence.[14]

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[9] Section 393 of the Companies Act.
[10] Section 414 of the Companies Act.
[11] Section 414 (4) & (5) of the Companies Act.
[12] Section 415(1) of the Companies Act.
[13] Section 418(2) of the Companies Act.
[14] Section 418(4) of the Companies Act.

8. A director who makes such a disclosure statement in a report falsely, or recklessly as to whether it was false, and failed to take steps to prevent the report from being approved, commits a criminal offence, punishable by imprisonment, or a fine, or both.[15]

9. The directors of a listed company must also prepare a directors' remuneration report for each financial year of the company.[16] Directors have additional obligations under the Listing Rules and the Disclosure and Transparency Rules. In particular, the directors must state that the business is a going concern, together with supporting assumptions or qualifications,[17] and a statement as to whether or not the company has complied throughout the accounting period with all relevant provisions set out in the UK Corporate Governance Code.[18]

Statutory and common law regarding the provision of statutory audit services

10. The statutory provisions relating to company audits are now consolidated in the Companies Act. In particular, Part 16 of the Companies Act provides for the statutory audit of companies (both registered and unregistered[19]) and of limited liability partnerships.[20] Statutory auditors may be appointed under other legislation but the general provisions of Part 16 of the Companies Act are applied, with modifications, to such audits.

11. Part 42 of the Companies Act (Statutory auditors—sections 1209 to 1264) specifies who may be appointed as a statutory auditor and has provisions to secure that audits

[15] Section 419(3) and (4) of the Companies Act.
[16] Section 420(1) of the Companies Act.
[17] Listing Rules 9.8.6R(3).
[18] Listing Rules 9.8.6R(6).
[19] In the case of unregistered companies, Part 16 of the Companies Act is modified by the Unregistered Companies Regulations 2009 (SI 2009/2436).
[20] In the case of limited liability partnerships, Part 16 of the Companies Act is modified by the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911).

are carried out properly, with integrity and with a proper degree of independence.[21] It gives effect to EU requirements for the approval and registration of persons that carry out statutory audits[22] which have replaced arrangements in the 8th Company Law Directive of 1984[23] (now repealed).

12. Part 15 of the Companies Act (Accounts and reports—sections 380 to 474) sets out the requirements as to accounts and reports in relation to each financial year of a company.

The statutory audit

13. A statutory audit is defined by the Companies Act by reference to the person appointed as auditor, but there are also provisions specifying the functions of a statutory auditor and matters which must be included in a statutory audit report.

14. The Companies Act defines a statutory audit[24] as an audit conducted by a person appointed as a statutory auditor, that is to say an audit conducted by a person appointed by a company,[25] a limited liability partnership, a building society,[26] a friendly society,[27] a Lloyd's syndicate,[28] an insurance undertaking[29] or a bank[30] in accordance with the provisions of the Companies Act. Part 16 of the Companies Act applies (in some cases with modifications) to all such financial audits. Our market investigation relates to company financial audits, as our terms of reference have limited the scope of 'statutory audit' by defining the expression 'statutory audit

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[21] Section 1209(b) of the Companies Act.
[22] Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts.
[23] Council Directive 84/253/EC (8th Company Law Directive—now repealed).
[24] Section 1210(1) of the Companies Act.
[25] Under section 485 (private companies) or section. 489 (public companies) of the Companies Act.
[26] Under section 77 of, or Schedule 11 to, the Building Societies Act 1986.
[27] By an insurer, that is a friendly society under section 72 of, or Schedule 14 to, the Friendly Societies Act 1992.
[28] Appointed as auditor for the purposes of regulation 5 of the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008 (SI 2008/1950) or to report on the 'aggregate accounts' within the meaning of those regulations: see section 1210(1)(e) of the Companies Act.
[29] For the purposes of the Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008 (SI 2008/565): see section 1210(1)(f) of the Companies Act.
[30] For the purposes of the Bank Accounts Directive (Miscellaneous Banks) Regulations 2008 (SI 2008/567): see section 1210(1)(g) of the Companies Act.

services' as meaning company audits carried out under Part 16 of the Companies Act.[31]

The duties of companies as regards audits

15. Companies and limited liability partnerships have a duty to commission statutory audits each financial year,[32] unless they are exempted[33] and the members have not exercised their right to require an audit, notwithstanding such exemption.[34] This requirement extends both to registered and unregistered companies.[35] The obligations placed on statutory auditors by Part 42 of the Companies Act (eligibility for appointment as statutory auditor etc) apply both to auditors appointed by companies and limited liability partnerships under Part 16 of the Companies Act, and to statutory auditors appointed under other legislative provisions.[36]

16. An auditor must be appointed for each financial year of the company, unless the directors reasonably resolve otherwise, on the ground that audited accounts are unlikely to be required.[37] If a company fails to make an appointment, it must notify the Secretary of State, and the Secretary of State may appoint a person to fill the vacancy.[38]

17. The appointment must be made, in the case of a public company, each year, before the end of the accounts meeting of the company at which the annual accounts and

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[31] 'For the purposes of this reference, statutory audit services means an audit conducted by a person appointed as auditor under Part 16 of the Companies Act 2006.' Terms of reference, paragraph 3.
[32] Under section 475 of the Companies Act, as modified in the case of limited liability partnerships by article 33 of the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911). Until 6 April 2008, the duty was on an auditor to audit the accounts, not on the company.
[33] Small companies and dormant companies are exempted under sections 477 and 480 respectively of the Companies Act. Non-profit-making companies subject to public sector audit are exempted by section 475(1)(b) of the Companies Act.
[34] Under section 476 of the Companies Act. Notification that an audit is required must be given by members representing not less than 10 per cent in nominal value of the company's issued share capital or any class of it, or not less than 10 per cent in number of the members of a company which has no share capital.
[35] The obligation on unregistered companies arises from the Unregistered Companies Regulations 2009 (SI 2009/2436).
[36] Section 2010(1) of the Companies Act.
[37] Section 485(1) of the Companies Act—private companies; section 489(1) of the Companies Act—public companies.
[38] Section 486(1) of the Companies Act—private companies; section 490(10) of the Companies Act—public companies.

reports for the previous financial year are laid.[39] In the case of a private company, the appointment must be made within 28 days of either the accounts for the previous year being circulated to members, or the end of the period allowed for circulating the accounts to members, whichever date falls first.[40]

18. An auditor of a public company holds office as auditor only for one year (ie until the conclusion of the next accounts meeting following appointment). The auditor may then be reappointed for a further period of one year, upon passing of a resolution by the shareholders.[41] An appointment must be made for each financial year.[42]

19. By contrast, an auditor of a private company will be deemed to be reappointed each year unless: *(a)* the appointment was made by the directors (not the members); *(b)* the company's articles require an actual reappointment; *(c)* enough members[43] have given notice to the company under section 488; *(d)* there has been a resolution that the auditor should not be reappointed; or *(e)* the directors decide that they do not need auditors for the following year.

20. The remuneration of an auditor, who has been appointed by the directors of a company, is fixed by the directors, and that of an auditor appointed by the members of a company may be fixed by the members[44] but, in practice, members pass a resolution authorizing the directors to fix the auditor's remuneration.

21. Small[45] and medium-sized[46] companies must disclose in a note to the annual accounts the fee paid to their auditors for the audit itself. Large companies (ie

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[39] Section 489 of the Companies Act.
[40] Section 485 of the Companies Act.
[41] Section 491(1)(b) of the Companies Act.
[42] Usually at the accounts meeting, section 489(2) of the Companies Act.
[43] ie 5 per cent or whatever lower figure is specified in the company's articles.
[44] Section 492 of the Companies Act.
[45] Section 382 of the Companies Act provides that a company is small if it satisfies two or more of the following requirements: (1) Turnover—not more than £6.5 million; (2) Balance sheet total—not more than £3.26 million; (3) Number of employees—not more than 50.

companies which are not small or medium-sized) must disclose both the audit fee and all other fees receivable by the auditors for services supplied by them and their associates to the company, its subsidiaries (with some exceptions) and associated pension schemes.[47] Consolidated group accounts of large companies must disclose the types of services and the fees paid for them, as if the group were a single company (in which case the individual companies do not need also to disclose them).[48]

22. If a company has made a liability limitation agreement with its auditors,[49] it must disclose, in a note to the accounts, the principal terms and the date of the approval resolution (or of the resolution waiving the need for approval, in the case of a private company) passed by the company's members. In practice, it is rare for such agreements to be made.

23. An auditor may resign from office by depositing a written notice to that effect at the company's registered office. The notice must be accompanied by a statement of any circumstances connected with the resignation which the auditor considers should be brought to the attention of the members or creditors of the company, or (where relevant and permitted) a statement that there are no such circumstances, and the notice of resignation is not valid unless this has been done.[50]

24. Section 519 of the Companies Act requires that an auditor who ceases to hold office must deposit a statement at the company's registered office explaining the relevant circumstances. This requirement applies also to an auditor who does not seek

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[46] Section 465 of the Companies Act provides that a company is medium-sized if it satisfies two or more of the following requirements: (1) Turnover—not more than £25.9 million; (2) Balance sheet total—not more than £12.9 million; (3) Number of employees—not more than 250.
[47] Under the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489) as amended by SI 2011/2198.
[48] ibid, regulation 7.
[49] In principle, an auditor has unlimited liability, but under sections 532–538 of the Companies Act, auditors are able to limit liability by contract with the company to an amount that is 'fair and reasonable in all the circumstances'. A separate agreement will be required for each year's audit, and each one must be approved by the company's shareholders.
[50] Section 516 of the Companies Act.

reappointment. The auditor must make a statement of any circumstances connected with this decision that the auditor considers should be brought to the attention of the members or creditors of the company, or a statement that there are no such circumstances.

25. Where an auditor ceases to hold office before the end of the relevant term of office or, in the case of a major audit, ceases for any reason to hold office, the auditor must notify the appropriate authority[51] which must forward the notice to the FRC.[52]

Who may conduct a statutory audit

26. An individual or firm[53] is eligible to be appointed as a statutory auditor if the individual or firm is a 'fit and proper person',[54] who is a member of a recognized supervisory body and is eligible for appointment under the rules of that body.[55] The Secretary of State was previously responsible for the oversight of statutory audits, but these functions as regards the public oversight of statutory audits required by the Audit Directive[56] have now been delegated to the FRC.

27. It is an offence for a person, who is ineligible to be appointed as a statutory auditor, to act as statutory auditor.[57] It is also an offence for a person to act as statutory auditor if that person lacks the necessary independence, by being an officer, partner or employee of the audited person, or an officer, partner or employee of an associated undertaking of the audited person.[58] If, while conducting a statutory audit,

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[51] Section 522 of the Companies Act.
[52] As from 2 July 2012. Formerly these functions were carried out by the Financial Reporting Review Panel of the FRC.
[53] For these purposes, 'firm' means any entity, whether or not a legal person, which is not an individual, and includes a body corporate, a corporation sole and a partnership or other unincorporated association: section 1261(1) of the Companies Act.
[54] Paragraph 8 of Schedule 10 to the Companies Act.
[55] Individuals who have retained Companies Act 1967 authorization, but are not otherwise eligible for appointment, may only audit an unquoted company (section 1222 of the Companies Act). In the cases to which the Companies Act section 1222 applies (individuals retaining only Companies Act 1967 authorization).
[56] Directive 2006/43 EC.
[57] Under section 1213 of the Companies Act.
[58] Under section 1215 of the Companies Act.

a person becomes ineligible or becomes prohibited by reason of lack of independence, that person must resign their office as auditor with immediate effect.

28. Where a partnership is appointed as statutory auditor, then unless a contrary intention appears, it is the partnership, not the partners, which is appointed. If the partnership ceases, and if the members of the successor partnership are substantially the same as those of the former partnership, and the partnership or person succeeds to the whole, or substantially the whole, of the business of the former partnership, the appointment will be treated as extending to the successor partnership or person.[59]

29. Section 1239 of the Companies Act requires that a register is kept of persons eligible for appointment as statutory auditor and third country auditors who apply to be registered. The Secretary of State has delegated the functions under this section to the FRC.[60] The register itself is maintained by ICAS on behalf of all RSBs.

30. The APB (now the Audit and Assurance Council (AAC) requires that in general, in the case of listed companies, the audit firm must establish policies and procedures to ensure that: *(a)* no one acts as audit engagement partner for more than five years; and *(b)* anyone who has acted as the audit engagement partner for a particular audited entity for a period of five years must not subsequently participate in the audit engagement in relation to that particular entity until a further period of five years has elapsed.

31. Shareholders may dismiss an auditor at any time by ordinary resolution at a general meeting, so long as special notice of the resolution has been given both to the share-

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[59] Section 1216 of the Companies Act.
[60] By the Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012, SI 2012 No 1741 and the Statutory Auditors and Third Country Auditors Regulations 2007, SI 2007 No 3494, as amended.

holders and to the auditor. The auditor can make representations in writing to the company which must be copied to the members (unless there is no time to do so).[61]

32. If a company removes an auditor from office by resolution, it must give notice to the registrar of companies and it is an offence committed by the company, and every officer who is in default, to fail to do so.[62]

33. An auditor may resign by depositing written notice with the company which includes a written statement of the circumstances connected with the auditor ceasing to hold office, unless the auditor considers that there are no such circumstances that need to be brought to the attention of members or of creditors of the company, in which case the auditor must deposit a statement to this effect.[63]

34. If an auditor of a listed company ceases for any reason to hold office, a statement of the circumstances connected with ceasing to hold office must be deposited by the auditor at the company's registered office.[64] The company must send a copy of the auditor's statement within 14 days to the persons who are entitled to be sent accounts, or make an application to the court.[65] If no application has been made to the court, the auditor must send a copy of its statement to the registrar of companies within 28 days of deposit.[66]

The functions of a statutory auditor

35. The two main functions of a statutory auditor are: *(a)* to obtain audit evidence and conduct an audit in accordance with ISAs (UK and Ireland); and *(b)* make a report to

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[61] Sections 510 & 511 of the Companies Act. Section 510 of the Companies Act is applied with modification to LLPs as from 1 October 2008 by the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911, regulations 2(1), (7) and 43).
[62] Section 512 of the Companies Act.
[63] Section 519 of the Companies Act.
[64] Section 519 of the Companies Act.
[65] Section 520 of the Companies Act.
[66] Section 521 of the Companies Act.

the company members on the annual accounts of the company identifying the financial reporting framework and the auditing standards that have been applied and, in particular, expressing an opinion on whether the annual accounts give a true and fair view of the state of affairs of the company at the end of the financial year, and of the profit or loss of the company for the financial year. Where the auditor is a firm, then the audit report must be signed and dated by the senior statutory auditor in their own name and on behalf of the audit firm.

36. An auditor has a general right of information for the purpose of preparing this report. This includes a right of access to the company's books, accounts and vouchers and a right to require any officer or employee of the company to provide such information or explanation as the auditor thinks necessary.[67]

37. Where a parent company has a subsidiary that is not incorporated in the UK, the auditor of the parent company may require it to obtain information or explanation for the purposes of the audit from any officer, employee or auditor of the subsidiary, any person holding or accountable for any of the subsidiary's books, accounts or vouchers, and any person who had such a position or was so accountable at the relevant time.[68]

38. It is an offence for a person knowingly or recklessly to make a statement (oral or written) of information required for the purposes of an audit that is misleading, false or deceptive in a material particular.[69] It is also an offence to fail to comply with a

[67] Section 499 of the Companies Act.
[68] Section 500 of the Companies Act.
[69] Section 501(1) of the Companies Act.

requirement to provide information for the purposes of an audit without delay, unless it was not reasonably practicable to provide the required information or explanation.[70]

39. An auditor is entitled to receive all notices of general meetings, and to attend and be heard at any general meeting of the company.[71]

40. The auditor must make a report on all the annual accounts of the company and express an opinion on the state of affairs and the profit and loss of the company. This report must be laid before the company in general meeting (in the case of a public company) or sent out to members (in the case of a private company).

41. The report must be either qualified or unqualified. 'Qualified'[72] means that the report or statement does not state the auditor's unqualified opinion that the accounts have been properly prepared in accordance with this Companies Act or, in the case of an undertaking not required to prepare accounts in accordance with this Companies Act, under any corresponding legislation under which it is required to prepare accounts. The report must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.

42. The auditor's report must state the name of the auditor and be signed and dated. Where the auditor is a firm, the report must be signed by the senior statutory auditor in their own name, for and on behalf of the audit firm.[73] The name of the audit firm, and of the senior statutory auditor who signed the report, must be stated in every copy of the report that is published or made available for public inspection,[74] unless the company: *(a)* considers on reasonable grounds that this would create a serious

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[70] Section 501(3) of the Companies Act.
[71] Section 502 of the Companies Act.
[72] Section 539 of the Companies Act.
[73] Section 503 of the Companies Act.
[74] Section 505 of the Companies Act.

risk that the audit firm, or senior statutory auditor, or any other person would be subject to violence or intimidation; *(b)* has resolved that the name should not be stated; and *(c)* has given notice of the resolution to the Secretary of State.[75]

43. The senior statutory auditor is the individual identified by the firm as senior statutory auditor in relation to the audit in accordance with Chapter 2 of Part 42 (sections 1212 to 1225) of the Companies Act[76] and the term 'senior statutory auditor' has the same meaning as the term 'engagement partner' when used in the ISA issued by the AAC.[77]

44. The senior statutory auditor is not, by reason of having signed the report or of being identified as senior statutory auditor, subject to any civil liability to which they would not otherwise be liable.[78]

45. If the auditor is of the opinion: *(a)* that adequate accounting records have not been kept; or *(b)* that the company's individual accounts are not in agreement with the accounting records and returns; or *(c)* in the case of a quoted company, that the auditable part of its directors' remuneration report is not in agreement with the accounting records and returns, then that fact must be stated in the report.[79]

46. If the auditor is of the opinion that the accounts are not in agreement with the accounting records, or if the auditor fails to obtain the information and explanations needed for the audit, this must be stated in the report.[80] The auditor must also state if the requirements[81] as to disclosure in the accounts of directors' benefits, remuneration, pensions and compensation for loss of office are not complied with, or

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[75] Section 506 of the Companies Act.
[76] Section 504(2) of the Companies Act.
[77] Bulletin 2008/6 of the Auditing Practices Board—The 'Senior Statutory Auditor' under the UK Companies Act 2006.
[78] Section 504(3) of the Companies Act.
[79] Section 498(2) of the Companies Act.
[80] Section 498 of the Companies Act.
[81] Under section 412 of the Companies Act.

requirements[82] are not complied with as to information concerning the auditable part of the directors' remuneration report.

47. The auditor's report must be either qualified or unqualified, and must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report. The report must state clearly: *(a)* whether in the opinion of the auditor the annual accounts give a true and fair view of affairs as at the end of the financial year of the company; *(b)* whether in its opinion the accounts have been properly prepared in accordance with the relevant financial reporting framework, the requirements of the Companies Act and, where applicable, Article 4 of the International Accounting Standards Regulation.[83]

48. The ISA state that it is not sufficient for the auditor to conclude that the financial statements give a true and fair view solely on the basis that the financial statements were prepared in accordance with accounting standards and any other applicable legal requirements.[84]

49. In addition, an auditor must state in the report whether, in its opinion, the information given in the directors' report for that financial year is consistent with the accounts.[85] If the company is a listed company, the auditor must also state in the report whether, in its opinion, the auditable part of the directors' remuneration report has been properly prepared in accordance with the Companies Act.[86]

50. Where the company prepares a separate corporate governance statement in respect of a financial year, the auditor must state in the report whether, in its opinion, the

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[82] Under section 421 of the Companies Act.
[83] Section 495 of the Companies Act.
[84] ISA 700 (revised October 2012) A 18.
[85] Section 496.
[86] Section 497.

information given in the statement describing the company's compliance with the rules on information about internal control and risk management systems in relation to financial reporting processes, and about share capital structures,[87] is consistent with the accounts.

The duties of a statutory auditor

51. Case law shows that the auditor must do more than check the arithmetical accuracy of the balance sheet. Lord Denning said:

> What is the proper function of an auditor? It is said that he is bound only to verify the sum, the arithmetical conclusion, by reference to the books and all necessary vouching material and oral explanations, and that it is no part of his function to inquire ... I think this is too narrow a view. An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. ... His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly, he must come to it with an inquiring mind—not suspicious of dishonesty, I agree—but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.[88]

52. According to Legatt LJ, the auditor must conduct the audit in such a way as to make it probable that material misstatements in financial documents will be detected:

> The primary responsibility for safeguarding a company's assets and preventing errors and defalcations rests with the directors. But material irregularities, and *a fortiori* fraud, will normally be brought to light by

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[87] Rules 7.2.5 & 7.2.6 in the *Disclosure Rules and Transparency Rules sourcebook*, issued by the FSA.
[88] *Fomento (Sterling Area) Limited v Selsdon Fountain Pen Co Ltd [1958] 1 WLR 45 (HL)*, p61.

sound audit procedures, one of which is the practice of pointing out weaknesses in internal controls. An auditor's task is so to conduct the audit as to make it probable that material misstatements in financial documents will be detected. Detection did not occur here, and there therefore is a case for C&LS to answer.[89]

The liabilities of a statutory auditor

53. Schedule 10 to the Companies Act requires a supervisory body: *(a)* to have rules and practices designed to ensure that statutory audit work is conducted properly and with integrity; *(b)* rules and practices as to the technical standards to be applied in statutory audit work, and the manner in which those standards are to be applied in practice; and *(c)* that persons appointed as statutory auditors of PIE (see paragraph 2) report to the entity's AC (if it has one) at least once in each calendar year during which they hold office. Schedule 10 also requires a supervisory body to monitor and enforce compliance with its rules.

54. Schedule 10 also provides that a supervisory body must have adequate rules or arrangements designed to ensure that statutory auditors take such steps as may reasonably be expected of them to secure that they are able to meet claims against them arising out of statutory audit work. The Companies Act provides that this may be achieved by professional indemnity insurance or other appropriate arrangements.

55. Auditors owe a duty to the company and the members of the company that has engaged them to exercise reasonable skill and care in carrying out their duties as auditors. Auditors are therefore at risk of claims for damages for breach. The scope of this duty was described by Lord Hoffman:

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[89] *Barings plc v Coopers & Lybrand [1997] 1 BCLC 427*, CA.

> A plaintiff who sues for breach of a duty imposed by the law (whether in contract or tort or under statute) must do more than prove that the defendant has failed to comply. He must show that a duty was owed to him and that it was a duty in respect of the kind of loss which he has suffered. Both of these requirements are illustrated by *Caparo* ... The auditors' failure to use reasonable care in auditing the company's statutory accounts was a breach of their duty of care. But they were not liable to an outside take-over bidder because the duty was not owed to him. Nor were they liable to shareholders who had bought more shares in reliance on the accounts because, although they were owed a duty of care, it was in their capacity as members of the company and not in the capacity (which they shared with everyone else) of potential buyers of its shares. Accordingly, the duty which they were owed was not in respect of loss which they might suffer by buying its shares.[90]

56. So in the case of a claim in tort against an auditor the claimant will generally be the company or the members of the company.[91] The claimant must prove: *(a)* that the relationship between the auditor and the claimant was capable of giving rise to a duty of care; *(b)* that the loss flowing from the auditor's breach of that duty was caused by the auditor's negligent report, and was foreseeable; *(c)* that a sufficient relationship of proximity exists between the auditor and the claimant; and (iv) that it is fair, just and reasonable in the circumstances that liability should be imposed.

57. Lord Phillips of Worth Matravers summarized the overall position as follows:

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[90] *South Australia Asset Management Corp v York Montague Ltd [1996] 3 All ER 365, [1997] AC 191* per Lord Hoffman at 211, cited in *Barings plc (in liq) & anor v Coopers & Lybrand (firm) & ors (No 1); Barings Futures (Singapore) Pte Ltd (in liq) v Mattar & ors (No 1)* [*2002] 2 BCLC 364* at 366.

[91] Cases such as *Royal Bank of Scotland Plc v Bannerman, Johnstone, Maclay [2005] ScotCS CSIH 39 show that it is a question of evidence whether the relationship between auditor and a third party claimant establishes a duty of care.*

The leading authority is *Caparo Industries Plc v Dickman* [1990] 2 AC 603. The duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant Auditing Standards. The duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the company in the interests of its shareholders. No duty is owed directly to the individual shareholders. This is because the shareholders' interests are protected by the duty owed to the company. No duty is owed to creditors—*Al Saudi Banque v Clarke Pixley* [1990] Ch 313. The Auditing Standards require auditors who have reason to suspect that the directors of a company are behaving fraudulently to draw this to the attention of the proper authority.[92]

'True and fair'

58. The obligation on the auditor to report whether the accounts in its opinion give a true and fair view of the state of the company's affairs apply:

- in the case of an individual balance sheet, to the state of affairs of the company as at the end of the financial year;
- in the case of an individual profit and loss account, to the profit or loss of the company for the financial year; and
- in the case of group accounts, to the state of affairs as at the end of the financial year, and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

59. There is no statutory definition of the phrase 'true and fair' and none of the decided 'auditor' cases appears to have attempted to define what is meant by 'true and fair'.

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[92] *Moore Stephens (a firm) v Stone Rolls Limited (in liquidation) [2009] 1 AC 1391.*

However, the same phrase is also relevant for tax law. In a leading case before the House of Lords, Lord Hoffman said:

> Although the requirement that the initial computation shall give a true and fair view involves the application of a legal standard, the courts are guided as to its content by the expert opinions of accountants as to what the best current accounting practice requires. The experts will in turn be guided by authoritative statements of accounting practice issued or adopted by the Accounting Standards Board.[93]

Further detail on the ASB (now the Accounting Council) is provided in paragraph 140. The FRC has a webpage which provides further materials on the meaning of 'true and fair'.[94]

60. Subsequently, in the Commercial Court, Andrew J Smith said:

> the expression 'true and fair view' has become established and accepted and given statutory force as a standard for preparing financial statements, and must be understood and given effect in light of generally accepted accounting practices, which are reflected in Financial Reporting Standards.[95]

61. It therefore appears in practice that the phrase equates to being computed in accordance with the relevant accounting principles. The FRC, through the Accounting Council, develops and publishes principles by which accounting standards can be established, and to provide a framework within which accounting issues can be resolved.[96]

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[93] *Revenue and Customs Commrs v William Grant & Sons Distillers Ltd [2007] UKHL 15*, paragraph 2.
[94] www.frc.org.uk/about/trueandfair.cfm.
[95] *Macquarie Internationale Investments Ltd v Glencore UK Ltd [2009] EWHC 2267 (Comm)*, paragraph 162.
[96] See www.frc.org.uk/asb/about/aims.cfm.

62. The following section describes how these principles have been developed and made concrete in practice by the accounting profession.

The definition and regulation of audit quality

63. In this section we describe the regulatory standards and guidance in relation to technical audit quality rather than a broader concept of audit quality.

Definition

64. As Professor Beattie pointed out in her review of academic literature,[97] the classic definition of audit quality has several dimensions, including technical competence, auditor independence, and the market's perception of these technical aspects. In addition, service quality aspects (such as responsiveness and non-audit services) are of interest to client company management. The FRC has stated[98] that audit quality is difficult to define and that there is no agreed definition of audit quality that can be used as a standard against which actual performance can be assessed. The AQRT has set out what it considers necessary to complete a quality audit in its public report on audit inspections, published in 2005:

> Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgments. …A quality audit [also] involves appropriate and complete reporting by the auditors which enables the Audit Committee and the Board properly to discharge their responsibilities.[99]

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[97] See www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/initial_review_of_relevant_academic_literature_in_the_audit_market.pdf

[98] Submission to the House of Lords Economic Affairs Committee: *Auditors: Market Concentration and their Role*, September 2010, paragraph 2.2: www.frc.org.uk/documents/pagemanager/frc/spotlight/Submission%20to%20HLEAC%20September%202010.pdf.

[99] Audit Inspection Unit, 2004/5 Audit quality inspections, Public report June 2005: www.frc.org.uk/images/uploaded/documents/Web%20optimized%20AIU%20Public%20Report%20200405.pdf.

65. De Angelo[100] defined audit quality as: 'the market-assessed joint probability that a given auditor will both *(a)* discover a breach in the client's accounting system and *(b)* report the breach'. Point *(a)* relates to the quality of the investigation that the auditor undertakes while point *(b)* relates to independence in terms of the auditor acting on the results of the investigation. 'Market assessed' relates to the perception of audit customers and other users of published audit reports.

66. Accordingly, it appears to match the two criteria proposed by the FRC of investigation and reporting.

67. The FRC published an *Audit Quality Framework* in February 2008.[101] It aimed to assist companies in evaluating audit proposals, ACs in undertaking annual assessments of the effectiveness of external audits, all stakeholders in evaluating the policies and actions taken by audit firms to ensure that high-quality audits are performed, and regulators when undertaking and reporting on the monitoring of the audit profession.

68. The Audit Quality Framework was intended to complement existing regulations and guidelines and listed the following drivers of audit quality:

(a) the culture within an audit firm;

(b) the skills and personal qualities of audit partners and staff;

(c) the effectiveness of the audit process;

(d) the reliability and usefulness of audit reporting; and

(e) factors outside the control of auditors affecting audit quality. These relate to corporate governance, audit committees, shareholders, reporting deadlines, appropriate limitation of liability, and regulatory environment.

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[100] De Angelo, L E (1981) 'Auditor size and audit quality', *Journal of Accounting and Economics*, 3(3): 93–199.
[101] www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web1.pdf.

69. KPMG disagreed with De Angelo's articulation of audit quality: it told us that from a purely regulatory perspective, audit quality was about whether in fact the auditor had done enough, of the right work, to achieve reasonable assurance that the accounts were free of material misstatement and had reported accordingly.

70. PWC also disagreed with the De Angelo definition as it made no reference to financial statements; a breach in a company's accounting system might not necessarily translate into *(a)* an error in the company's financial statements or *(b)* a matter that affected audit quality.

71. The remainder of this section:

(a) describes regulatory standards regarding the conduct of an audit of financial statements; and

(b) sets out the regulatory requirements of auditor independence.

Standards regarding audit

72. Auditing standards are professional standards or requirements for the performance of an audit of financial statements.

73. The FRC publishes ISAs, based on ISAs issued by the International Auditing and Assurance Standards Board (IAASB), which deal with the responsibilities of an auditor in conducting an audit of financial statements (see further paragraphs 138 to 232).

74. New standards were issued by the IFAC through the IAASB (see paragraph 223 onwards) and were adopted in the UK in October 2009 as ISAs (UK and Ireland), and apply to audits of financial statements for periods ending on or after 15 December 2010. Where necessary, the FRC has augmented the international standards with a

small number of additions to address specific UK and Irish legal and regulatory requirements. At the same time a revised version of the International Standard on Quality Control (ISQC1) was released by the IAASB and adopted in the UK as ISQC1 (UK and Ireland).

75. There are over 30 ISAs (UK and Ireland) that address the following broad areas: quality control and documentation; audit planning and communication; risk assessment and planned responses; audit procedures and evidence; audit of group financial statements; auditor reporting; and other specialized areas. They provide detail on particular procedures.[102] For example:

(c) ISA 220 'Quality control for an audit of financial statements'[103] outlines the requirements including engagement leader responsibilities and documentation.

(d) ISA 500 'Audit evidence'[104] outlines what is sufficient appropriate audit evidence, and selecting items for testing to obtain audit evidence.

(e) ISA 600 'Special Considerations—Audits of group financial statements (including the work of component auditors)'[105] states that, among other things, with regard to group audits where the audit firm (carrying out the group audit) engages another audit firm (carrying out some of the component audits), the group audit firm is responsible for the group audit and should carry out sufficient work and obtain sufficient appropriate audit evidence across the group to reduce audit risk to an acceptably low level.

76. The FRC also publishes Practice Notes which contain guidance on the application of certain ISAs (UK and Ireland) to the audit of certain entities or situations (eg banks,

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[102] Recent standards relevant to audit include: ISA 260 Communication with those charged with governance; ISA700 The auditor's report on financial statements (Revised); ISA705 Modifications to the opinion in the independent auditor's report; ISA706 Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report; ISA720A The auditor's responsibilities relating to other information in documents containing audited financial statements (all effective from 1 October 2012) www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-issues-revised-auditing-standards-to-enhance-c.aspx.

[103] www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20220%20(Feb%202012).pdf.

[104] www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20500%20(Feb%202012).pdf.

[105] www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20600%20(Feb%202012).pdf.

building societies, complex financial instruments, charities etc) and bulletins which provide guidance on new and emerging issues involving indicative best practice. See further paragraph 153 and following.

77. In addition to auditing standards, audit firms are required to comply with the ISQC 1 (UK and Ireland). ISA (UK and Ireland) 220 explains that quality control systems, policies and procedures are the responsibility of the audit firm and under ISQC1 (UK and Ireland), the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) the firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) the reports issued by the firm or engagement partners are appropriate in the circumstances.

78. ISQC1 (UK and Ireland) provides a common language and framework that can be used by firms and their networks of all sizes to establish, communicate and monitor policies and procedures designed to support auditors conducting audit engagements; and regulators when evaluating firm compliance with requirements.

79. The IAASB illustrates the linkage between ISAs and ISQC1 thus: In a broader context, ISA220 (UK and Ireland) and ISQC1 establish a framework for quality control in two specific dimensions—at the audit engagement level and at the firm level, respectively. Together, these two standards address a variety of areas where auditors and their firms can take specific action to promote and safeguard audit quality.

Auditor 'independence'

80. Regulation requires auditor 'independence' to ensure that auditors report objectively on their findings. This subsection covers the FRC and the UK framework for ensuring auditor independence. It then considers the ethical standards surrounding auditor independence and examples of safeguards for specific circumstances, including:

(a) the rules on non-audit services that firms can provide for audit clients;

(b) the rules concerning the ownership of audit firms by qualified auditors;

(c) rules concerning personal independence (arising from financial interests such as loans or shareholdings or personal or business relationships); and

(d) rules on audit partner rotation.

The FRC and the UK framework for ensuring auditor independence

81. The UK framework for auditor independence is issued by the FRC. There are five Ethical Standards[106] in total concerned with the integrity, objectivity and independence of auditors. These standards apply to all audits of financial statements and there are additional provisions regarding audits of listed companies. The Standards contain requirements and guidance. They take a principles-based approach which involves examining if there are threats and (if found), putting in place safeguards to eliminate or reduce the threats to an acceptable level. This is described in more detail in paragraph 84.

82. 'Ethical Standard 1: integrity, objectivity, and independence' (ES1)[107] describes the importance of integrity, objectivity and independence for an auditor; ways of complying with ethical standards (policies and procedures, leadership, ethics partner); identification and assessment of threats and safeguards; and engagement quality control review.

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[106] The Ethical Standards were published by a former operating body of the FRC, the APB (see paragraphs 138 to 232).
[107] www.frc.org.uk/images/uploaded/documents/ES%201%20revised%201210%20updated%201211.pdf.

83. The ICAEW also provides regulations and guidance as to an auditor's obligations in its updated version of its Audit Regulations and Guidance (published December 2011; effective 1 January 2012).[108] Firms registered with the ICAEW must comply with the Audit Regulations and Guidance.

Threats to independence

84. ES1 sets out the principal types of threats to the auditor's objectivity and independence:

(a) self-interest threat;

(b) self-review threat;

(c) management threat;

(d) advocacy threat;

(e) familiarity (or trust) threat; and

(f) intimidation threat.

85. The ICAEW's Regulations and Guidance[109] list the following situations as some of those that might threaten a firm's independence, as they have the potential to affect an auditor's obligations:

(a) undue financial dependence on an audit client;

(b) personal or family relationships;

(c) beneficial or other interests in shares or other investments in an audit client;

(d) beneficial interest in a trust that has investments in an audit client;

(e) involvement as a trustee in an audit client;

(f) loans to or from an audit client;

(g) participation in the business affairs of an audit client; and

(h) voting on audit appointments.

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[108] ICAEW Audit Regulations and Guidance, January 2012: www.icaew.com/en/members/regulations-standards-and-guidance/audit/audit-regulations-and-guidance.
[109] ICAEW Audit Regulations and Guidance, January 2012: www.icaew.com/en/members/regulations-standards-and-guidance/audit/audit-regulations-and-guidance.

Safeguards for independence

86. If the AEP identifies threats to the auditor's objectivity, including any perceived loss of independence, the partner must identify and assess the effectiveness of safeguards in order to eliminate the threats or reduce them to an acceptable level. Where the audit engagement partner chooses to reduce rather than eliminate a threat to objectivity and independence, the partner must recognize that this judgement may not be shared by users of the financial statements and may be required to justify the decision (ES1).

87. In circumstances where it is not possible to eliminate the threats or reduce them to an acceptable level, the auditor must either not accept or withdraw from the audit engagement (ES1).

88. As set out in paragraph 80 (and following the notation there), the remainder of this section considers *(b)* the rules on non-audit services that firms can provide for audited entities, *(c)* the rules concerning the ownership of audit firms by qualified auditors, *(d)* rules concerning personal independence (arising from financial interests such as loans or shareholdings or personal or business relationships with clients), *(e)* rules on audit partner rotation.

Rules on non-audit services for audited entities

89. Ethical Standard 5[110] (ES5) sets out requirements and guidance on specific circumstances arising from the provision of non-audit services by audit firms to entities audited by them. There are specific restrictions but not a total ban on non-audit services.

[110] *APB Ethical Standard 5 (Revised): Non-Audit Services Provided to Audited Entities*: www.frc.org.uk/images/uploaded/documents/ES%205%20revised%201210%20updated%201211.pdf.

90. ES5 distinguishes between ‘audit service’, ‘audit-related service’ and ‘other non-audit service’. Audit-related service refers to work which is done on financial information and/or controls, which is integrated with the work performed largely by the existing audit team, and on the same terms and conditions as the audit but is not done to enable the auditor to provide an audit opinion. Other non-audit service refers to any other service provided by the auditor to the audited entity as well as the audited entity’s affiliates or other entities in respect of the audited entity. The list of audit-related services contained in ES5 is in Annex A to this appendix.

91. Any threats to auditor independence from audit-related services are considered to be insignificant under ES5, as the work involved is closely related to the work performed in the audit.

92. The threats from self-interest, self-review, management, and advocacy (of the threats listed in paragraph 84, these four are discussed in ES5) that may arise with regard to the provision of non-audit services, and the possible safeguards, are considered below.

Self-interest threat

93. According to ES5, a ‘self-interest threat’ may arise where substantial fees for an audit firm are regularly generated from the provision of non-audit services and where the fees for non-audit services are greater than the annual audit fees. In this situation the audit partner must assess the possibility of a perceived loss of independence. Having made the assessment, the audit partner will either determine that the threats to independence are at an acceptable level, or reduce them to an acceptable level by putting in place acceptable safeguards (eg separate engagement teams), and inform the people charged with governance (presumably the audit committee, among others).

94. Under ES5, in the case of listed companies, where the non-audit fees are expected to be greater than the annual audit fees, the audit partner must provide details to the ethics partner of the audit firm and discuss the matter.

95. The situation is more complex in the case of contingent fees, which is addressed in ES4 and ES5. An audit firm must not accept a non-audit service engagement on a contingent fee basis where: *(a)* the fee is material to the audit firm, or that part of the firm by reference to which the audit partner's profit share is calculated; or *(b)* the outcome of the service (and therefore the fee) is dependent on a future or contemporary audit judgement relating to a material matter in the financial statements of an audited entity (Ethical Standard 4: Fees, remuneration and evaluation policies, litigation, gifts and hospitality (ES4)).[111] ES4 additionally requires notification of proposed contingent fees for non-audit services to the audit engagement partner and the ethics partner and disclosure of actual contingent fees to the audit committee in writing in respect both of the auditor and its network firms. ES5 additionally prohibits contingent fees for tax services where the outcome of those tax services is dependent on the proposed application of tax law which is uncertain or has not been established.

Self-review threat

96. According to ES5, a self-review threat exists where the results of a non-audit service performed by the audit firm are reflected in the amounts included or disclosed in the financial statements. A threat to objectivity or independence arises because, in the course of the audit, the auditor may need to re-evaluate the work it has performed in the non-audit service; the auditor is (or may appear to be) unable to take an impartial view of relevant aspects of those financial statements. ES5 also recognizes that any

[111] www.frc.org.uk/images/uploaded/documents/ES%204%20revised%202010.pdf.

inability to take an impartial view may be more a matter of appearance rather than fact.

97. There are certain non-audit services discussed in ES5 which may never be carried out by the audit firm, for example:

(a) an audit firm cannot carry out accounting services to an audited entity that is a listed company or a significant affiliate of such an entity, or to an audited entity where those accounting services would involve the audit firm undertaking part of the role of the management;[112] and

(b) an audit firm cannot undertake internal audit services to an audited entity where it is reasonably foreseeable that the auditor would place significant reliance on the internal audit work performed by the audit firm, or that the audit firm would undertake part of the role of management.

Management threat

98. According to ES5, a management threat exists when the audit firm undertakes work that involves making judgements and taking decisions which are properly the responsibility of management. ES1 prohibits partners and employees of the audit firm from taking decisions on behalf of the management of the audited entity.

99. A threat to objectivity and independence arises if the auditor becomes closely aligned with the views and interests of management (which may erode the distinction between the audited entity and the audit firm) which in turn may impair the auditor's ability to apply a proper degree of professional scepticism.

[112] There is an exception to the general prohibition, whereby in emergency situations the audit firm may provide an audited entity that is a listed company (or a significant affiliate of such a company) with accounting services to assist the company in the timely preparation of its financial statements.

Advocacy threat

100. According to ES5, an advocacy threat exists when the audit firm undertakes work which involves acting as an advocate for an audited entity and supporting a position taken by management in an adversarial context. This is because the auditor could become too closely aligned with the management of the audited entity and it then may be difficult for the auditor to take an impartial view during the audit.

Safeguards

101. Under ES5, if a threat is identified and safeguards can be applied that would be effective to eliminate the threat or reduce it to an acceptable level, then the non-audit service may be provided. Where no safeguards are applied, and where the threat is above an acceptable level, the audit firm must not provide the non-audit service, or must withdraw from the audit engagement. If the threat is already at or below an acceptable level then the auditor could do the work without applying safeguards and without resigning.

102. Safeguards may include separate teams; or review by the audit firm engagement quality control review partner determining that the audit judgements, if any, relating to the non-audit service are sufficient and that the conclusions of the audit team are appropriate.

Rules concerning the ownership of audit firms by qualified auditors

103. Schedule 10, Part 2, of the Companies Act contains the rules governing ownership of audit firms which differ depending on whether the firm is a partnership or a 'body corporate'. These are also in the ICAEW Audit Regulations and Guidance, which also require each partner (whether an audit partner or not) to be 'fit and proper'.

104. The ownership, control and management rules set out below mean that it may currently be more difficult than otherwise for audit firms to access external capital to fund expansion.

Ownership

105. The Companies Act states that, if the firm is a partnership, the partners must be chartered accountants (or affiliates of a registering institute).[113] If the firm is a body corporate, there are no restrictions on who may be a shareholder.

Control

106. If the firm is a partnership, and where the partners have equal voting rights, then at least a majority of the partners must be individuals with an appropriate qualification (as defined by legislation),[114] registered auditors or combination of both. In any other case at least a majority of the voting rights must be held by qualified individuals, registered auditors or combination of both.

107. If the firm is a body corporate, then (in contrast to the requirement for ownership (see paragraph 105) the majority of shareholders' voting rights must be held by qualified individuals, registered auditors or combination of both.

Management

108. If the firm is a partnership, and where the policies are set and implemented by a management committee, board or other body, then at least a majority of the voting rights in that body must be held by qualified individuals, registered auditors or a combination of both.

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[113] That is, a member of the ICAEW, ICAS and/or the CAI, or a member of the ACCA.
[114] A qualification as defined by section 1219 of the Companies Act or section 187 of the RI 1990 Companies Act.

109. If the firm is a body corporate, then at least the majority of voting rights in the board of directors, committee or other management body must be held by qualified individuals, registered auditors or a combination of both. In addition, each director must be a chartered accountant or registered auditor.[115]

Personal independence (arising from financial, business, employment and personal relationships)

110. ES2 includes provisions on specific circumstances arising out of financial, business, employment and personal relationships in the audited entity. The general principle is that the auditor must make an assessment as to the threat to the auditor's objectivity and independence, and put in place safeguards where necessary. There are some situations where the threat is such that no safeguards can eliminate them to an acceptable level. ES4 includes provisions on fees, which are discussed from paragraph 124 onwards.

Financial interests

111. Financial interest is defined in the Ethical Standards[116] as an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such an interest.

112. The general prohibitions outlined in the following paragraphs are subject to certain limited relaxations.[117] The audit firm, any partner in the audit firm, a person in a position to influence the conduct and outcome of the audit or an immediate family member must not hold: any direct financial interest in the audited entity or an affiliate of the audited entity; any indirect financial interest where the investment is material to the audit firm or individual; or any indirect financial interest where the person holding it has both the ability to influence the investment decisions of the intermediary and

[115] That is, a member of the ICAEW, ICAS and/or the CAI, or a member of the ACCA.
[116] APB Ethical Standards Glossary of Terms: www.frc.org.uk/images/uploaded/documents/Glossary%20ES%20revised%202010.pdf.
[117] See paragraph 7 of ES2.

actual knowledge of the existence of the underlying investment in the audited entity or an affiliate of the audited entity.

113. ES2 states that where a direct financial interest or a material indirect financial interest in the audited entity is held by the audit firm or by one of the individuals specified in paragraph 112, then disposals of the relevant financial interests must be made as soon as possible.

114. There are specific regulations on loans and guarantees. Audit firms, persons in a position to influence the conduct and outcome of the audit and immediate family members must not make a loan to, or guarantee the borrowings of, an audited entity unless this represents a deposit made with a bank or similar deposit-taking institution in the ordinary course of business. There are similar regulations relating to loans from an audited entity to an audit firm and additionally the loan must not be material to the firm or the audited entity.

115. The guidance in ES2 states that loans by a bank or similar institution (for example, mortgage, overdraft, car loan) to a person in a position to influence the outcome of the audit do not create an unacceptable threat to objectivity and independence, unless the loans are in arrears by a significant amount, in which case this creates an intimidation threat which is unacceptable. Such loans are acceptable only where they are on normal business terms and are not material to the audited entity.

Business relationships

116. Unless in the ordinary course of business, audit firms, persons in a position to influence the conduct and outcome of the audit and immediate family members must not enter into a business relationship (meaning two parties having a common commercial interest) with the audited entity. The business relationship must also be

at arm's length and immaterial. Where a business relationship is not in the ordinary course of business, it must be clearly inconsequential to both the audited entity and the audit firm. Where a business relationship has been entered into that is not permitted, it must be terminated. Safeguards may need to be adopted until the relationship is terminated, for example a restriction on a member of staff working on the audit team. If the business relationship is not permitted the other option to terminating it is to resign the audit.

117. Where a close family member to one of the influencers noted above enters into a business relationship with the audited entity, the influencer must report the matter to the AEP and/or the ethics partner to take appropriate action.

Employment relationships

118. There are restrictions on who can undertake audit work. An audit firm cannot employ or admit to its partnership a person who is also employed by the audited entity, nor may one of its employees undertake the audit work in respect of an audit client in which they are also an employee.

Staff loan assignments

119. An audit firm must not agree to loan a member of staff to an audited entity unless *(a)* the agreement is for a short period of time and does not involve staff or partners performing non-audit services which are not permitted under ES5 (for example, accounting services) and *(b)* the audited entity agrees that the individual concerned will not hold a management position.

120. Where a partner or member of staff returns to the audit firm, that individual must not be given any role on the audit involving any function or activity that he or she performed during the assignment.

Partners and team members joining an audited entity or former employees of the audited entity joining the audit firm

121. Where a former partner in the audit firm joins an audited entity, the audit firm must take action to ensure that no significant connections remain between the firm and the individual (for example, all capital balances and financial interests settled). Where a partner leaves the audit firm and is appointed director or to a key management position within the audited entity, having acted as audit engagement partner in the past two years, the firm must resign as auditor, and cannot be reappointed for another two years. Where a former member of the audit team (other than partner) joins the audited entity, the audit team must consider whether the composition of the audit team is appropriate; if the team member joins as a director or in a key management position there would be a similar two-year cooling-off period as for the AEP.

122. Where a former director or employee of the audited entity, who was in a position to exert significant influence over the preparation of the financial statements, joins the audit firm, that person must not be assigned to a position in which they are able to influence the conduct and outcome of the audit for two years.

Family and personal relationships

123. There are requirements for an audit firm to have policies and procedures in place to safeguard against the threat to objectivity or perceived loss of independence arising from family and personal relationships.

Fees

124. The AEP must ensure that audit fees are not influenced or determined by the provision of non-audit services to the audited entity.

125. An audit must not be undertaken on a contingent fee basis.[118]

126. There are specific provisions where the total fees for both audit and non-audit fees receivable from a listed company by the audit firm will regularly exceed 10 per cent of the annual fee income of the audit firm (or 15 per cent for non-listed companies). The firm must not act as auditor and must either resign or not stand for reappointment, as appropriate. Where the proportion is between 5 and 10 per cent for a listed company (or between 10 and 15 per cent for non-listed companies), the AEP must consider appropriate safeguards to eliminate or reduce the threat to the auditor's objectivity and independence. The AEP must also inform the ethics partner and those charged with governance if the non-audit fees are regularly between 5 and 10 per cent (listed companies) and 15 and 20 per cent (non-listed companies) and for non-listed companies will arrange an external independent quality control review of the audit engagement prior to finalization of the audit report.

Auditor rotation

127. The requirement for audit partner rotation is in the FRC's Ethical Standard 3 (revised) 'Long Association with the Audit Engagement' (ES3).[119]

128. There is a general provision that an audit firm should have policies and procedures to monitor the length of time that audit engagement partners and key partners and staff in senior positions (including those from other disciplines) work on the engagement team. Where they have a long association with the audit, the firm should assess the threats to objectivity and independence, and then consider the safeguards.

129. There is no specific requirement for audit firms of non-listed companies to rotate an AEP, but there is guidance that after holding the role for a continuous period of ten

[118] See paragraph 95.
[119] ES3: www.frc.org.uk/images/uploaded/documents/Glossary%20ES%20revised%202010.pdf.

years, careful consideration is given as to whether there is a loss of perceived objectivity and independence. Safeguards must be applied to reduce any threats to an acceptable level and after an AEP has been in place ten years, either safeguards are applied or the reason why not is documented and the facts reported to those charged with governance. Additionally, the audit firm has to consider which non-listed entities ought to be treated as listed entities.

130. There are additional provisions related to the audits of listed companies:

(a) No one shall act as an AEP[120] for a particular company for more than five years, and anyone who has been AEP for a particular company should not participate in that audit engagement for another five years.

(b) No one shall act as the engagement quality control reviewer[121] or key audit partner[122] for a particular company for longer than seven years, and the AEP shall review the safeguards in place to address the threats to the auditor's objectivity and independence where partners and senior staff have been involved in the audit for more than seven years. The engagement quality control reviewer must have a five-year cooling off period. If the engagement quality control reviewer or other key partner becomes the audit partner, the combined period of service in these positions shall not exceed seven years.

(c) A key audit partner involved in the audit for seven years shall not participate until a period of two years has elapsed.

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[120] The engagement partner is the partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

[121] An engagement quality control review is a process designed to provide an objective evaluation, before the report is issued, of the significant judgements the engagement team has made and the conclusions they reached in formulating the report.

[122] The key audit partner is an audit partner of the assurance team (including engagement partner) who is at group level responsible for reporting on significant matters, such as on significant subsidiaries or divisions of the financial statement audit client, or on significant risk factors that relate to the financial statement audit of that client.

Other issues relating to audit quality

Transparency reporting

131. The FRC has stated that transparency reporting by major audit firms has a significant role to play in encouraging audit quality:[123]

(a) by helping investors and potential buyers of audit services to understand the strengths of a particular audit firm. There are similarities to the workings of the UK Corporate Governance Code (see paragraph 158 onwards) in that relatively weak or inadequate disclosures by a firm can be seen as adding a risk factor to the use of that firm; and

(b) clear public information on, for example, the firm's processes and practices for quality control, for ensuring independence, for partner remuneration, on their governance and network arrangements provides a clear incentive to all within the firm to live up to the both the spirit and the letter of what the firm promises.

132. Until recently, most audit firms published very limited information about themselves. Most were structured as partnerships, with no statutory requirement for external reporting. Two factors changed this, at least for the largest firms:

(a) Following the Limited Liability Partnerships Act 2000, all the largest firms adopted the LLP form, which requires accounts and reports much as for a limited liability company.

(b) Following the Enron scandal, the Government concluded in January 2003 that there was a legitimate public interest in the public availability of information on those firms which audit PIE and 13 out of the 20 largest audit firms gave a voluntary undertaking to meet these proposals. Most major firms incorporated 'transparency' information as part of their annual report and accounts prepared

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[123] www.frc.org.uk/images/uploaded/documents/POB%20trans%20consdocument%20final.pdf, Professional Oversight Board: *Transparency Reporting by Auditors of Public Interest Entities. A consultation document on the implementation of article 40 of the 8th Company Law Directive on the statutory audit of annual accounts*, July 2006.

as an LLP, although they did not identify specific information separately as a 'transparency report'.

133. In March 2009, the Consultancy Committee of Accountancy Bodies (CCAB) published a Voluntary Code of Practice on Disclosure of Audit Profitability, which applied in respect of accounting periods beginning on or after 6 April 2009. This was as a result of Recommendation 2 of the final report of the Market Participants Group established by the FRC in October 2006, which was published in October 2007. Recommendation 2 stated: 'Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.' The FRC invited the CCAB to develop guidance to audit firms on the voluntary disclosure of this information. The Code of Practice applies to any UK audit firm that is a 'major firm' (see paragraph 171).

134. The Statutory Audit Directive, agreed in 2006, introduced a mandatory requirement for auditors of PIE to produce transparency reports. In the UK, this requirement was given effect through the Statutory Auditors (Transparency) Instrument 2008, published by the FRC[124] following consultation, and applied to any relevant audit firm's financial year commencing on or after 6 April 2008.

135. Firms must disclose the following, within three months of the firm's financial year end:

(a) description of the legal structure and ownership of the transparency reporting auditor;[125]

(b) where the transparency reporting auditor belongs to a network, a description of the network and the legal and structural arrangements of the network;

(c) a description of the governance of the transparency reporting auditor;

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[124] Published by a former operating body of the FRC—the Professional Oversight Board (POB) (see paragraphs 195–197).

[125] A transparency reporting auditor is defined by regulation 2(1) of the Statutory Auditors (Transparency) Instrument 2008 as a statutory auditor that has made an audit report on the annual accounts of one or more public interest entities at any time during the financial year of that statutory auditor.

(d) a description of the internal quality control system of the transparency reporting auditor and a statement by the administrative or management body on the effectiveness of its functioning;

(e) a statement of when the last monitoring of the performance by the transparency reporting auditor of statutory audit functions took place;

(f) a list of PIE in respect of which an audit report has been made by the transparency reporting auditor in the financial year of the auditor;

(g) a description of the transparency reporting auditor's independence procedures and practices including a confirmation that an internal review of independence practices has been conducted;

(h) a statement on the policies and practices of the transparency reporting auditor designed to ensure that persons eligible for appointment as a statutory auditor continue to maintain their theoretical knowledge, professional skills and values at a sufficiently high level;

(i) financial information for the financial year of the transparency reporting auditor to which the report relates, including showing the importance of the transparency reporting auditor's statutory audit work; and

(j) information about the basis for remuneration of partners.

Confidentiality

136. Conflicts of interest arising from having confidential information about a client's competitors are dealt with in the ICAEW Code of Ethics.[126] An auditor must respect the confidentiality of information acquired from one client and not disclose the information to another party unless there is a legal or professional right or duty to do so, or use the information for the personal advantage of the auditor or third parties.

[126] www.icaew.com/en/technical/ethics/icaew-code-of-ethics/icaew-code-of-ethics.

137. Following the description of the applicable law and the regulation governing the quality of audits and independence of auditors, we turn to the institutions tasked with enforcing that regulation.

Regulatory bodies and mechanisms

138. This section describes the institutional architecture that has been established to ensure the quality of audits and the appropriate conduct of auditors, and to develop accounting standards. In particular, it briefly describes the history of the institutional framework and then describes the current role, function and interaction of:

(a) the FRC;

(b) the professional accounting bodies, and their role as Recognised Qualifying Bodies (RQBs) and Recognised Supervisory Bodies (RSBs);

(c) the FSA;

(d) international bodies and legislation; and

(e) other relevant bodies.

139. In addition to the auditing and ethical standards issued by the FRC, the UK audit regulatory framework is determined by UK and European legislation and regulation, and by financial reporting standards issued by the international and UK accounting standards boards (in the case of the UK, the FRC).

Brief history of the institutional framework

140. The FRC was originally set up in the early 1990s as a private sector body tasked with promoting high-quality financial reporting. It consisted of two bodies, the ASB and the Financial Reporting Review Panel, which respectively set UK accounting standards and reviewed listed companies' compliance with those standards.

141. Formed in 2000, the Accountancy Foundation provided independent and non-statutory oversight of the regulation of the six chartered accountancy bodies of the CCAB (see paragraph 228 onwards). The Accountancy Foundation's remit extended to the way the professional bodies conducted their audit supervision role, although the statutory responsibility to ensure adequate technical and other standards for auditors was with the professional bodies. The Accountancy Foundation had four subsidiary bodies: the Review Board, the APB, the Ethics Standards Board, and the Investigation and Discipline Board.

142. Following the auditing failures in the USA at Enron and WorldCom, the Government concluded in January 2003[127] that there should be a strengthening of the regulatory framework for corporate governance, auditing and financial reporting, and recommended that the FRC take on formal responsibilities for audit and accountancy regulation.

143. The Companies Act 1989, and subsequently the Companies (Audit, Inspection and Community Enterprise) Act 2004 provided the legislative basis for the regulatory structure relating to audit. As a part of this, from September 2005 the Government gave the FRC the responsibilities and powers to oversee and monitor the system of audit regulation that the Government had previously exercised directly. The provisions of the 2004 Act are now largely incorporated into the Companies Act.

144. More recently the Companies Act and the Statutory Auditors and Third Country Auditors Regulations 2007[128] made further changes to the statutory framework, in particular to give full effect in the UK to the requirements of the Statutory Audit Directive (2006/43/EC).

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[127] *Review of the Regulatory Regime of the Accountancy Profession* ('the Swift Review'): www.bis.gov.uk/files/file20417.pdf.
[128] SI 2007 No 3494 www.legislation.gov.uk/uksi/2007/3494/pdfs/uksi_20073494_en.pdf.

The FRC

145. The FRC is the UK's independent regulator responsible for promoting high-quality corporate governance and reporting to foster investment. It has statutory and non-statutory responsibilities.[129] It is funded mainly by a levy from public companies and accountancy professional bodies, and a small amount from BIS and a levy from public sector organizations.[130]

146. In June 2012, reform of the FRC was given parliamentary approval by the House of Commons and the House of Lords. The reforms, which took effect as of 2 July 2012, enable the FRC to operate as a unified regulatory body, with enhanced independence from those it regulates, and a more proportionate range of sanctions. Prior to 2 July 2012, the FRC's regulatory responsibilities in relation to audit and the accounting profession were exercised through its operating bodies; the FRC structure comprised a board managing seven individual operating bodies supported by the FRC's professional staff.

147. As of 2 July 2012, the strategic direction of the key decisions on standards, and how the organization discharges its responsibilities, is undertaken by the FRC Board.

Structure of the FRC

148. The FRC Board is supported by three committees: the Codes and Standards Committee, the Conduct Committee and the Executive Committee. The Codes and Standards Committee advises the FRC Board on matters relating to codes, standard-setting and policy questions, through its Accounting, Actuarial and Audit and Assurance Councils. The Conduct Committee advises the FRC Board in matters

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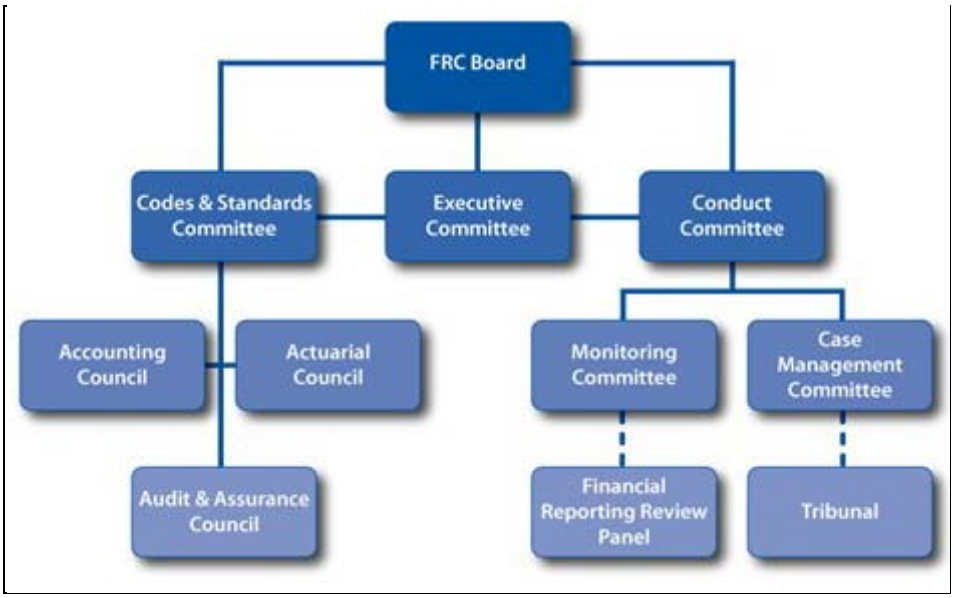
[129] As from 2 July 2012, the existing delegation of functions of the Secretary of State under the Act concerning auditors was replaced by a new delegation in favour this new body—the Financial Reporting Council Limited. (The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012, SI 2012 No 1741.)

[130] For 2012/13 the costs for accounting, auditing and corporate governance are £12 million; audit inspection costs are £3 million (met by the RSBs with which the audit firms are registered); and accountancy disciplinary case costs are £4 million (met by the accountancy professional bodies to which the individuals or firms which are subject to each case belong within the terms of a formal case-costs agreement).

relating to conduct activities to promote high-quality corporate reporting, including monitoring, oversight, investigative and disciplinary functions, through its Monitoring Committee and Case Management Committee. The Executive Committee supports the Board by advising on strategic issues and providing day-to-day oversight of the work of the FRC. The structure of the FRC is shown in Figure 1.

FIGURE 1

FRC current structure



Source: FRC.

149. The functions and objectives of the FRC are carried out by two divisions, Codes and Standards, and Conduct. Both divisions carry out work which is relevant to this investigation:

(a) The FRC's Codes and Standards Division develops and maintains standards and guidance for Audit and Assurance engagements which are performed in the public interest within the UK and Republic of Ireland. It also seeks to influence the development of international auditing and assurance standards and policy developments that are relevant to its remit.

(b) The FRC's Conduct Division undertakes a number of activities that are relevant to auditors:

(i) The AQRT monitors the quality of the audits of listed and other major PIEs and the policies and procedures supporting audit quality at the major audit firms in the UK.

(ii) The FRC is the independent disciplinary body for accountants and accountancy firms (including auditors and audit firms) in the UK. Its Professional Discipline team deals with cases of potential misconduct which raise or appear to raise important issues affecting the public interest in the UK.

(iii) The Professional Oversight team has a number of statutory responsibilities delegated to the FRC by the Secretary of State for Business, Innovation and Skills, and by agreement with the six chartered accountancy bodies, the team also exercises independent oversight of the regulation of the accountancy profession by the professional accountancy bodies.

Codes and standards

150. The FRC promotes corporate reporting and governance by setting standards and publishing codes for directors and investors to implement. This corporate governance regime is enforced by the principle of 'comply or explain', which the FRC believes 'has been shown to accelerate best practice in the boardroom and puts investors in the key role of holding directors to account'[131]. Further detail on corporate governance is found in paragraphs 238 to 245.

151. The FRC's work in this division relates to audit and assurance, corporate governance, and accounting and reporting policy.

[131] www.frc.org.uk/Our-Work/Codes-Standards.aspx.

Audit and assurance

152. The principal activities of the Audit and Assurance team within the Codes and Standards Division of the FRC are as follows.

153. Codes and Standards develops and maintains auditing and assurance standards and guidance for engagements that are performed in the public interest with the UK and Republic of Ireland. It has published a variety of documents including mandatory standards and practice notes and bulletins which are guidance only. In relation to statutory audit, it has issued:

(a) ISAs (UK and Ireland). These contain the objectives and requirements in planning and performing every audit, and are engagement standards.

(b) International Standards on Quality Control (UK and Ireland). These are quality control standards.

(c) The Auditors' Code. This is a framework of fundamental principles which encapsulate the concepts that govern the conduct of audits and underlie the FRC's ethical and auditing standards.[132]

(d) Ethical Standards for auditors, and ISAs (UK and Ireland).

(e) Practice Notes and Bulletins. These are guidance, not requirements.

154. It also issues standards and guidance for the work of reporting accountants in connection with investment circulars, standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence, and guidance for the provision of assurance on client assets.

155. The Audit and Assurance team also contributes to the FRC's Codes and Standards, Influencing and Research activities that cut across Audit and Assurance, Accounting and Reporting Policy, Governance and Actuarial Policy.

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[132] The Auditor's Code has the following headings: accountability; integrity; objectivity and independence; competence; rigour; judgement; clear, complete and effective communication; association; and providing value.

156. The team also seeks to ensure that the FRC point of view is appropriately considered by the IAASB, through actively participating in the development of the IAASB's international standards and guidance that are relevant to the FRC's remit. The IAASB's issues the ISAs that provide the basis for the FRC's ISAs (UK and Ireland).

157. It also undertakes and commissions research on matters of relevance to audit and other assurance engagements that are performed in the public interest.

Corporate governance

- *UK Corporate Governance Code*

158. The FRC publishes the UK Corporate Governance Code (the Code (formerly the Combined Code)) which sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. Further detail is found in Annex C.

159. In addition to the Code, the FRC publishes a series of guidance notes intended to assist companies address specific aspects of governance and accountability. They cover board effectiveness, risk management and internal control, the role of ACs, and assessing and reporting on whether the business is a going concern.

- *Audit Firm Governance Code*

160. In January 2010 the FRC and ICAEW published the Audit Firm Governance Code. The Code was the result of a recommendation in the October 2007 report of the FRC's Market Participants Group that 'every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation'. An independent working group, supported by the ICAEW, produced the Audit Firm Governance Code, and recommended that the code should be applicable to those firms that audit more than

20 listed companies and that it should apply to financial years beginning on or after 1 June 2010.

161. The code applies to eight audit firms[133] that together audit about 95 per cent of the companies listed on the Main Market of the London Stock Exchange. The code sets a benchmark for good governance which other audit firms may voluntarily wish to adopt in full or in part. It also codifies much existing good practice and links to matters that audit firms must comply with as regulated professional partnerships. The FRC monitors the extent to which these firms comply with the code, and also engages directly with the Independent Non-Executives which the firms have appointed under one of the code's key provisions.

Accounting and reporting policy

162. One role of the FRC is to issue accounting standards. It is recognized that for that purpose under the Companies Act 1985. The FRC took over the role in July 2012 following its reorganization from the ASB. The ASB took over the task of setting accounting standards from the Accounting Standards Committee in 1990.

163. Accounting standards aim at enabling accounts to be prepared so as to give a true and fair view. This aids comprehension and allows comparability for users who rely on them for investment and other decision-making purposes. Accounting standards aim at being principles (not rules) based, and therefore judgement remains a very significant factor in their application. Accounting standards apply to all companies and other kinds of entities which prepare accounts that are intended to give a true and fair view. These set out:

(a) the accounting treatments permissible for an individual event or transaction; and

[133] Baker Tilly LLP, BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton LLP; KPMG LLP, PKF LLP, PricewaterhouseCoopers LLP.

(b) disclosure requirements: these state the permissible layouts (called formats) for the balance sheet and profit and loss account items, required note disclosures and the level of detail required.

164. Accounting standards formerly developed by the ASB are contained in Financial Reporting Standards (FRSs). Soon after it started its activities, the ASB adopted the standards issued by the ASC, so that they also fall within the legal definition of accounting standards. These are designated 'Statements of Standard Accounting Practice'. Whilst some of the Statements of Standard Accounting Practice have been superseded by FRSs, some remain in force.

165. A single entity company that does not produce consolidated accounts is not required to follow IFRS, but could still apply UK GAAP.[134] UK companies which have securities listed on an EU-regulated market and that have to prepare consolidated accounts now have to follow IFRS, which are published by the International Accounting Standards Board (IASB).[135]

166. The FRC collaborates with accounting standard-setters from other countries and the IASB both in order to influence the development of international standards and in order to ensure that its standards are developed with due regard to international developments.

167. The Accounting Council of the FRC has up to ten part-time members who represent a variety of interests.

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[134] Generally Accepted Accounting Practice in the UK (UK GAAP) is the body of accounting standards and other guidance formerly published by the ASB. As from 2015, UK GAAP will be replaced by new accounting standards issued by the FRC.
[135] Although the IASB sets standards, those standards are only applicable in EU countries if endorsed by the EU.

International Financial Reporting Standards

168. There are a variety of accounting standards in current use. On 1 April 2001 the IASB, as far as future international accounting standards were concerned, renamed IAS as IFRS. These have been compulsory for listed companies in the EU since 2005. Although the IASB sets standards, those standards are only applicable in EU countries if endorsed by the EU Although the ASB's intention was for IFRS to have largely been adopted into UK Financial Reporting Standards (FRS), it has not occurred in practice. Some FRS, such as the three on financial instruments, copy the IFRS/ISAs directly, but FRS and IFRS are still separate sets of standards. Work by the IASB on convergence of the different standards used in different international jurisdictions continues.

Conduct

169. The FRC's Conduct division encompasses the FRC's monitoring, oversight, investigative and disciplinary functions. Its work includes:

(a) direct monitoring of financial reports and audits of public interest entities;

(b) oversight of the regulation of the audit, accountancy and actuarial professions by their respective professional bodies;

(c) inquiring into current market issues;

(d) operating a disciplinary scheme for major public interest cases involving auditors, accountants and actuaries; and

(e) research and thematic studies.

170. Each function is described in more detail below.

Audit Quality Review

171. The AQRT monitors the quality of the audits of listed and other major PIEs and the policies and procedures supporting audit quality at the major audit firms[136] in the UK. Prior to July 2012 this was carried out by the Audit Inspection Unit, part of the FRC's POB. The overall objective of the FRC's work is to monitor and promote improvements in the quality of auditing of listed and other major public interest entities. The audits of all UK incorporated entities with listed securities (both equity and debt) and other UK entities whose financial condition is considered to be of major public interest are within the scope of the FRC's work under the Companies Act. A description of all such entities is published annually.[137]

172. 'Major Firms',[138] plus the Big 4 firms, are subject to full-scope inspections which include a review of their firm-wide policies and procedures supporting audit quality, as well as a sample of individual audit engagements. The Big 4 firms are subject to inspection on an annual basis and the other Major Firms on an extended cycle of up to three years. The FRC's work at other firms is limited to periodic reviews of one or more audits with its scope (with the review of these firms' policies and procedures being delegated to the professional body with which they are registered for audit purposes, in particular the Quality Assurance Department of the ICAEW).

173. The FRC applies a risk-based monitoring approach in selecting individual audits for review, using a risk model covering listed and AIM listed entities. Its reviews of individual audits place emphasis on the appropriateness of key audit judgements made in reaching the audit opinion and the sufficiency and appropriateness of the

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[136] A 'major firm' is a firm that performs more than ten major audits as defined in paragraph 13 of Schedule 101 to the Companies Act. Paragraph 13 defines a 'major audit' as a statutory audit conducted in respect of *(a)* a public interest entity, or *(b)* any other person in whose financial condition there is a major public interest. The FRC determines which entities fall into the category of a 'public interest entity'.

[137] In March 2012, the FRC announced the scope of its inspection work for 2012/13. In addition to all UK incorporated companies with listed securities (main market and small cap), the main categories are AIM quoted companies with a market capitalization in excess of £50 million, UK unquoted companies with group turnover in excess of £500 million, and UK banks and building societies not captured in the above categories.

[138] BDO, Baker Tilly, Crowe Clark Whitehill, Grant Thornton, Mazars, and PKF.

audit evidence obtained. Its reviews of firm-wide procedures are wide-ranging in nature and include an assessment of how the culture within firms impacts on audit quality.

174. The FRC's approach focuses on audit judgements as well as on processes, and is based on the following characteristics:

(a) focus on the quality of auditing: each year the FRC selects areas of particular focus. For 2011/12 these were: group audit considerations; the valuation of assets held at fair value; the impairment of assets (including goodwill and other intangibles); the assessment of going concern; revenue recognition; related parties; and the quality of reporting to ACs;

(b) thorough, robust and challenging approach to inspection visits;

(c) wide-ranging views of firm-wide procedures, including an assessment of how the culture within firms impacts on audit quality: for example, 'tone at the top' and international communications; independence and ethics; and client risk assessment and acceptance/continuance;

(d) risk-based selection of individual audits for review, using a risk model covering listed and AIM listed entities;

(e) in-depth reviews of individual audits, addressing identified areas of risk and including critical assessment of key audit judgements made in reaching the audit opinion. The assessment of key audit judgements are not just about judgements as to audit procedures but also about judgements as to the propriety of the accounting; and

(f) an assessment of the quality of communications with the AC.

175. The FRC's work covers, but is not restricted to, compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. This includes the auditing standards, ethical standards and quality control standards for

auditors issued by the FRC (see paragraphs 73 to 76) and the Audit Regulations issued by the relevant professional bodies. The FRC identifies areas where improvements are, in its view, required to safeguard or enhance audit quality and/or comply with regulatory requirements. It seeks to agree an action plan with each firm inspected designed to achieve the improvements needed, and assesses the adequacy of the progress made by the firm in addressing the findings within a year of the action plan being finalized.

Private reports

176. The key issues arising from its reviews of individual audit engagements and its review of firm-wide procedures are set out in a private report to the professional body with which the firm is registered (the ICAEW or the ICAS); these reports are discussed with the firms at a senior level before they are finalized.

177. It also issues confidential reports on individual audits reviewed to the relevant audit firms. A key element of the FRC's reporting requirements is that firms are expected to provide copies of these reports to the directors of the audited entities concerned and confirm to the FRC that they have done so.

Public reports

178. The FRC publishes individual reports on the inspections of Major Firms and an overall report on the inspections of Smaller Firms, as well as an annual report with an overview of activities.

179. In the individual report for each major firm and the overall report for the smaller firms, the FRC bands each audit into one of three categories considering a variety of factors:[139]

(a) good with limited improvements required;

(b) acceptable but with improvements required; and

(c) significant improvements required.

180. In the confidential reports provided to audit firms by the FRC, four categories of finding are used: *(a)* good; *(b)* acceptable with limited improvements required; *(c)* acceptable overall with improvements required and *(d)* in need of improvements which are individually or collectively significant. The first two categories are combined for public reporting purposes.

181. 'Significant improvements required' means 'the [FRC] had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of audit judgements in one or more key audit area, or the implications of concerns relating to other areas are considered to be individually or collectively significant'. The FRC notes that this type of assessment does not necessarily imply that an inappropriate audit opinion was issued.

182. The FRC also publishes an annual report which provides an overview of its activities and the principal findings from its work; individual reports on its 2010/12 and 2011/12 inspections of major firms have also been published.

183. Significant change has taken place in the audit regulatory environment since 2004 when the large audit firms responsible for the statutory audit of public interest entities became subject to independent inspections of the firm and, as part of that, of a

[139] Sufficiency of audit evidence; Quality of audit evidence; Appropriateness or otherwise of audit judgements; Evidencing of thought processes underlying audit judgements; Existence and extent of concerns in other areas.

sample of their audits. Since 2005 there has been a public report on the overall findings of the inspections focused on audit quality and independence and, since 2008, there have been public reports on the individual inspections of audit firms (they were previously private). In addition, the reports of the inspections of specific company audits are made available to the ACC of that company, providing greater information to the company to inform the AC's discussions on the effectiveness of the auditor and the review of the appointment. KPMG told us that, taken with the UK transparency and audit firm governance requirements, the UK had the most open, robust and transparent independent regulation, certainly among the International Forum of Independent Audit Regulators member countries.

Corporate Reporting Review

184. In its Corporate Reporting Review work the FRC's Conduct Committee seeks to ensure that the provision of financial information (mainly directors' reports and accounts) by public and large private companies complies with relevant reporting requirements.

185. Directors prepare accounts and auditors audit and report on them. The FRC's corporate reporting review work does not duplicate what directors and auditors do, and it does not offer advice on the application of accounting standards or the accounting requirements of the Companies Act. Directors are responsible for the accuracy of the accounts and their judgements; the FRC's role is to enquire into cases where it appears that the requirements have not been followed—primarily where it appears that there is, or may be, a question whether the directors' report or accounts complied with the requirements of the Companies Act.

186. The FRC's corporate reporting review team develops and operates a programme of review of annual accounts based on risk assessment, and selects accounts for

review in a number of ways. Each year priority sectors are announced. In December 2011, the panel announced that commercial property, retail and support services would be sectors of focus for 2012/13. The areas of focus for 2011/12 were commercial property, insurance, support services and travel. In all cases the selection is based on the FRC's assessment of the risk of non-compliance and the risk of significant consequences if there is non-compliance.

187. The FRC can ask directors to explain apparent departures from reporting requirements, and if it is not satisfied by the directors' explanations it aims to persuade the directors to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their accounts and replace them with revised accounts; depending on the circumstances the FRC may accept another form of remedial action, for example, correction of the comparative figures in the next set of annual financial statements. Failing voluntary correction, the FRC can exercise its powers to secure the necessary revision of the accounts through a court order. The FRC's predecessor body, the Financial Reporting Review Panel, succeeded in resolving all cases on a voluntary basis and without having to apply for a court order.

Professional discipline

188. The FRC is the independent disciplinary body for accountants, accountancy firms and actuaries in the UK. It operates two separate disciplinary schemes, one for the accountancy profession and one for the actuarial profession. We focus on the Accountancy Scheme in this appendix.

189. The Accountancy Scheme operates independently of the professional bodies, with the Conduct Committee having oversight over the operation of the disciplinary arrangements. A majority of its members are non-accountants. The Conduct Committee's responsibilities are:

(a) operating an independent disciplinary scheme for the investigation of cases which raise or appear to raise important issues affecting the public interest and where appropriate, bringing disciplinary proceedings against those whose conduct appears to have fallen short of the standard reasonably to be expected of members or member firms of the relevant professional body;

(b) keeping under review the working of the scheme and the supporting regulations to ensure that they are operating effectively; and

(c) regular publicity for the FRC's disciplinary activities and achievements as appropriate.

190. The Accountancy Scheme covers members and member firms of the following bodies: ICAEW, CIMA, CIPFA, CAI, ACCA and ICAS.

191. The FRC deals with cases of potential misconduct which raise or appear to raise important issues affecting the public interest in the UK. All other cases of potential misconduct continue to be dealt with by the professional bodies above.

192. The FRC's aim is to (1) safeguard the public interest by protecting the public, maintaining public confidence in the accountancy profession and declaring and upholding proper standards of conduct by accountants, (2) provide a demonstrably fair and independent system for investigating, and where appropriate, taking disciplinary action in significant public interest cases of potential misconduct, (3) imposing appropriate sanctions where misconduct has been proved, and (4) seeking to deter future misconduct.

193. In brief, the stages of the disciplinary process are: decision to investigate; investigation; decision whether to bring disciplinary proceedings against any firm or

individual; referral to disciplinary tribunal; tribunal hearing; determination and imposition of sanction and/or costs orders.

194. The FRC can start a disciplinary investigation in one of two ways: (1) the professional bodies can refer cases to the FRC, and (2) the FRC may decide of its own accord to investigate a matter.

Professional Oversight

195. The Professional Oversight team has the following statutory responsibilities delegated to the FRC by the Secretary of State for Business, Innovation and Skills:

(a) independent oversight of the regulation of statutory auditors by the recognized supervisory and qualifying bodies (the RSBs and RQBs—see paragraph 202 onwards);

(b) independent supervision of Auditors General (head of the National Audit Office) in respect of the exercise of their function as statutory auditors;

(c) the regulation of auditors ('third country auditors') of companies outside the European Economic Area that have issued securities to trading on UK-regulated markets; and

(d) the receipt of statutory change of auditor notifications from companies and statutory auditors in respect of 'major audits'.

196. By agreement with the six chartered accountancy bodies, the Professional Oversight team also exercises independent oversight of the regulation of the accountancy profession by the professional accountancy bodies. The team also reports annually to the Secretary of State for Business, Innovation and Skills on the findings from the work done by the team.

197. The former operating body of the FRC responsible for professional oversight (the POB), and the Public Company Accounting Oversight Board (PCAOB) signed an agreement in January 2011 recognizing the need to cooperate and share information in matters relating to the oversight of auditors subject to the regulatory jurisdictions of both the PCAOB and the POB, including joint inspections. For UK companies which are registered with the Securities and Exchange Commission, their auditors must register with the PCAOB and are subject to inspection by the PCAOB. These inspections have been taking place at each of the large firms.

Supervisory inquiries

198. A supervisory inquiry is a cross-conduct exercise looking into a matter of concern affecting a public interest entity. Although each inquiry is different, it will include a technical review of the latest (and prior) financial statements, a review of certain aspects of the latest (and prior) audit files, discussions with other regulators, and a report to the Conduct Committee. Examples of situations which may merit a supervisory inquiry include a major corporate collapse or near collapse shortly after the release of the company's annual report, a major fraud, a significant restatement (of the accounts), and widespread concerns over the quality of reporting or governance on a particular issue.

199. The Conduct Committee is responsible for considering the results of a supervisory inquiry and determining the appropriate outcome. This may be referral for a formal investigation with a view to potential disciplinary action either by the FRC or the relevant professional body, inviting the Monitoring Committee to proceed in accordance with their normal procedures governing the monitoring of corporate reports and audits, publication of a report of the inquiry's findings, recommendation for an issue to be considered by the relevant part of the Codes and Standards division, referral to another regulatory body, or no further action.

FRC and choice: Market Participants' Group

200. The FRC created the Market Participants' Group (MPG) in October 2006 in order to provide advice to the FRC on possible actions that market participants (ie companies, investors and audit firms) would take to mitigate the risks arising from the characteristics of the market for audit services to public interest entities in the UK. The MPG issued 15 recommendations in October 2007, intended to allow the audit market to work more efficiently and, in the medium to long term, to increase audit choice in the UK.[140] Among these were recommendations (which are listed in full in Annex D to this appendix) that ACs explain their choice of auditor; that shareholders take a greater interest in audit selection; and that the FRC promote understanding of audit quality. It was hoped that greater transparency and shareholder engagement would lead to more choice in the audit market.

201. Since publication of the recommendations, the FRC has made five progress reports (the last was in June 2010) on the implementation of the recommendations. The fourth progress report explained that the majority of the MPG recommendations had been implemented and that the FRC's role was now to monitor the effectiveness of that implementation. However, by the time of the fifth progress report, although 14 of the 15 implementations had been implemented, the FRC found limited evidence that the recommendations had had a significant impact on market concentration and the risks arising from that concentration. Many of the recommendations were guidance only and could not be enforced: for example, more than half of listed companies surveyed by the FRC ignored guidance that ACs should provide information on frequency of audit tenders and on tenure of incumbent auditor.[141]

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[140] Final report of Audit Choice Market Participants Group published: www.frc.org.uk/press/pub1420.html.
[141] www.frc.org.uk/images/uploaded/documents/Choice%20in%20the%20UK%20Audit%20Market%20Fifth%20Progress%20Report.pdf.

The Professional Accounting Bodies

202. Accountancy as such is not subject to statutory regulation in the UK and there are a large number of private bodies that represent and regulate groups of accountants. Of these the best known are the six bodies which have a Royal Charter:

(a) ACCA;

(b) CIMA;

(c) CIPFA;[142]

(d) ICAEW;

(e) CAI; and

(f) ICAS.

203. As at 31 December 2010 there were just over 300,000 members across these bodies in the UK and the Republic of Ireland, with nearly half (115,000) being members of the ICAEW.

204. Audit firms which wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, an RSB. Individuals responsible for audit at registered firms must hold an audit qualification from an RQB.[143]

205. RQBs and RSBs are recognized by and monitored subject to oversight by the FRC (see paragraph 195 above).

RQBs

206. RQBs award the qualifications necessary to undertake audit work, as an entry requirement. There are five RQBs[144] comprising four chartered bodies (ACCA,

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[142] There are very few CIPFA and CIMA members employed in public practice at 1 and 3 per cent of each institute's membership respectively.

[143] The Statutory Auditors (Registration) Instrument 2008 (POB 02/2008) and The Statutory Auditors (Examinations) Instrument 2008 (POB 03/2008). The powers were delegated to the POB under Article 3(1)(a) of the Statutory Auditors (Delegation of Functions etc) Order 2008 ('the Order') made under sections 504(4)(1)(b)(ii), 1252(1), (4)(a), (5) and (8) and 1253(4) of, and paragraphs 7(3), 11(2) and 3(a) of, Schedule 13 to the Companies Act.

ICAEW, CAI, and ICAS and the Association of International Accountants. RQBs must have rules and arrangements in place to register students and track their progress, administer examinations and ensure that appropriate training is given to students in an approved environment.

RSBs

207. There are four principal RSBs. These are: the ACCA; the ICAEW; the CAI; and the ICAS. In addition the Association of Authorised Public Accountants is an RSB but it is now a subsidiary of the ACCA and for all practical purposes its small number of members is regulated by the ACCA.

208. RSBs must have procedures in place to register and de-register statutory auditors and supervise work undertaken by these individuals and firms, and to this end they carry out four main tasks: audit registration (see paragraph 204); audit monitoring; arrangements for the investigation of complaints; and procedures to ensure that those eligible for appointment as statutory auditor continue to maintain an appropriate level of competence (continuous professional development).

209. Under the procedures followed by ICAEW, ICAS and CAI, an individual who wishes to undertake audit work must *(a)* hold an audit qualification and *(b)* be approved as a Responsible Individual (RI). An RI is an individual who takes responsibility for carrying out an audit on behalf of a registered audit firm and may be a principal (ie partner) or an employee of the registered audit firm. An RI cannot accept an audit appointment unless the firm in which the individual works is also a registered audit firm. An RI must be approved by the relevant professional body and the audit firm's audit compliance principal must vouch for their integrity, fit and proper status and

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[144] CIPFA was recognized as an RQB by the then Department of Trade and Industry in 2005, subject to conditions, but did not at that time develop fully the examinations and arrangements for practical training needed for the award of the statutory auditor qualification. CIPFA agreed to hold its RQB status in abeyance until 2012.

competence. The ACCA has similar procedures but instead of accrediting individuals as RIs it grants them an audit practising certificate.

210. Statutory Audit Directive (effective from April 2008 in the UK) introduced a requirement that the RSBs should monitor the activities undertaken by audit firms at least once every six years. This replaced the less prescriptive requirements in the 1989 Companies Act that RSBs had procedures in place to monitor their registrants, with the RSB left to decide the frequency.

The ICAEW

211. The ICAEW is described here in more detail as it has the most auditors compared with the other RSBs. As at 31 December 2011 there were 7,375 registered audit firms, of which 3,864 were registered through the ICAEW, and approximately 67 per cent of the total fee income of audit firms registered with the ICAEW was attributable to the Big 4 firms.

212. To be admitted to membership of the ICAEW, applicants must generally complete 450 days of relevant work experience (training) and pass a series of examinations. The work experience lasts between three and five years and must be with an employer or employers approved by the institute for training.

213. The ICAEW describes itself as a professional membership organization, supporting over 138,000 chartered accountants around the world; through its technical knowledge, skills and expertise, it provides insight and leadership to the global accountancy and finance profession. Its public interest objective is key: the ICAEW states that it provides its 'members with knowledge and guidance based on the highest ethical and technical standards' and that it 'shapes opinion, understanding

and delivery to ensure the highest standards in business and in the public interest'. It also issues occasional technical releases relevant to auditing.

214. The ICAEW's board has overall responsibility for ICAEW's planning and budgeting process and the development of policy, and is supported by four boards that oversee the main areas of ICAEW activity: professional standards, learning and professional development, member services and technical strategy.

215. The objectives in its Royal Charter are to:

(a) advance the theory and practice of accountancy, finance, business and commerce;

(b) recruit, educate and train a body of members skilled in accountancy and finance;

(c) preserve at all times the professional independence of accountants;

(d) maintain high standards of practice and professional conduct by all members; and

(e) advance the profession of accountancy.

The FSA

216. The FSA is the independent organization responsible for regulating financial services in the UK. Under the Financial Services and Markets Act 2000 it has four statutory objectives: market confidence, financial stability, consumer protection, and the reduction of financial crime.

217. Although statutory audit does not come directly under the scope of regulation by the FSA, confidence in published accounts (as well as high-quality reporting in respect of client assets) is important to the FSA's objectives of market confidence, financial stability and consumer protection. In addition, other activities carried out by account-

ancy firms, such as arranging deals in investments or advising on investments, may come under the scope of regulation by the FSA.[145]

218. In July 2010 the Government issued proposals to disband the FSA and establish a new system of more specialized and focused financial services regulators, including the establishment of a new Prudential Regulation Authority as a subsidiary of the Bank of England. The relevant provisions of the Financial Services Act 2012, which gives effect to this, come into force on 1 April 2013.

Interaction with FRC

219. In January 2011, the FSA and FRC agreed a new memorandum of understanding to enable a greater degree of cooperation and information exchange between the two regulators. It follows the publication of a joint discussion paper on the audit of financial institutions published in June 2010, entitled *Enhancing the auditor's approach to prudential regulation*,[146] which considered ways of enhancing auditors' contribution to regulation, in particular following the financial crisis of 2008.

220. The purpose of this June 2010 paper was to stimulate debate on how the FSA can best use audit and auditors to meet its statutory objectives. In particular, the paper examined how the FSA, the FRC and auditors can best work together to enhance how auditors can contribute to prudential regulation in the future.

[145] Auditors are required to report to the FSA as a prudential regulator in relation to audit clients: for example, under ISA (UK and Republic of Ireland) 250: Section B The Auditor's Right and Duty to Report to Regulators in the Financial Sector, and the recent FSA 'Code of Practice for the relationship between the external auditor and the supervisor'.
[146] www.frc.org.uk/images/uploaded/documents/FSA%20FRC%20Discussion%20paper1.pdf.

International bodies and legislation

Sarbanes-Oxley

221. As part of the Sarbanes-Oxley Act of 2002 (commonly called 'Sarbox' or 'SOX'),[147] the Securities and Exchange Commission issued very strict requirements regarding auditor independence, setting new or enhanced standards for all US public company boards, management and accountancy firms. It applies to many of the largest UK companies as they are listed in the USA and created a new reporting requirement on auditors to report on the effectiveness of internal control of the audited entity. The legisation was enacted as a reaction to a number of major corporate and accounting scandals including Enron and Worldcom. It also created a new, quasi-public agency, the PCAOB, charged with overseeing, regulating, inspecting and disciplining accountancy firms in their roles as auditors of public companies. The Sarbanes-Oxley Act also covered issues such as auditor independence, corporate governance, internal control assessment and enhanced financial disclosure. This is a prescriptive rules-based approach compared with the UK's principles-based approach (see paragraph 238 onwards).

222. PwC told us that there were three important dimensions to the effect of SOX, and that it had been a major feature in raising the bar for regulation of the audit process in the UK:

(a) it increased the substantive complexity of the audit;

(b) it increased the extent of disclosures in company reporting, which required additional auditor input; and

(c) it introduced stricter requirements for the independence of the company's AC and auditors (including a ban on the provision of certain non-audit services).

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[147] Also known as the 'Public Company Accounting Reform and Investor Protection Companies Act' and 'Corporate and Auditing Accountability and Responsibility Companies Act'.

IFAC

223. The IFAC is a worldwide body with the mission of serving the public interest by: contributing to the development, adoption and implementation of high-quality international standards and guidance; contributing to the development of strong professional accountancy organizations and accounting firms, and to high-quality practices by professional accountants; promoting the value of professional accountants worldwide; and speaking out on public interest issues where the accountancy profession's expertise is most relevant. The UK is represented on IFAC's board and its various committees.

IAASB

224. The IAASB is an independent standard-setting body under the auspices of IFAC which sets standards for auditing, review, other assurance and related services engagements, and quality control, by facilitating the convergence of international and national standards. It develops and issues (among other publications) ISAs.

IESBA

225. The IESBA is an independent standard-setting body under the auspices of the IFAC which sets standards for professional accountants and facilitates the convergence of international and national ethical standards, including auditor independence requirements, through a code of ethics. The major audit firm networks have agreed to observe the IESBA code of ethics: although the FRC's ethical standards may incorporate or go further than the IESBA code, in some cases the IESBA code sets a higher standard to be applied.

IASB

226. The IASB is the independent accounting standard-setting body of the IFRS Foundation based in London and is responsible for developing IFRS and promoting

the use and application of those standards. The IASB has 15 members each with one vote, who are each experts with a mix of experience of standard setting, preparing and using accounts, and academic work.

International Forum of Independent Audit Regulators

227. The International Forum of Independent Audit Regulators was established in 2006 and focuses on the following activities:

(a) sharing knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms;

(b) promoting collaboration and consistency in regulatory activity; and

(c) providing a platform for dialogue with other international organizations that have an interest in audit quality.

CCAB

228. The CCAB was founded in 1974 by the six UK accountancy bodies formed by royal charter (ACCA, CIMA, CIPFA, ICAEW, CAI and ICAS) and is an umbrella group for the major British professional accounting bodies. CIMA left the CCAB in March 2011, leaving the remaining five accountancy bodies.

229. The CCAB provides a forum whereby its member bodies can meet and act collectively on behalf of the accountancy profession in the UK to promote the public interest on matters within the sphere of the profession and its members.

230. The combined membership of the five bodies amounts to 236,000 professional accountants in the UK and the Republic of Ireland (334,000 worldwide). The CCAB has four strategic objectives:[148]

(a) Current and Emerging Issues: to provide a forum for considering current and emerging issues and agreeing joint approaches to the FRC, Government and other authorities, both national and international, on behalf of the UK profession and, in particular, where significant public interest issues are at stake.

(b) Maintaining Identity: to maintain and develop CCAB's identity as the collective voice of the UK profession.

(c) Representing views to international standard setters, regulators and other bodies: to provide a mechanism for influencing the global profession by representing the views of the UK profession to international standard setters, regulators and other bodies, including the making of nominations to international organizations.

(d) Joint Approaches: to facilitate joint project-based thought leadership, technical work and research on behalf of the UK profession, where this enhances the 'collective voice' and adds value for the bodies.

231. CCAB does not undertake any education or training activities; these are matters for the individual professional bodies.

Interaction with other bodies

232. The CCAB Ethics Group coordinates activities between the member bodies relating to ethical guidance and liaises with relevant FRC standard setting and oversight boards, in respect of ethical issues. This includes discussions with the APB regarding auditor independence issues, application of the IFAC requirement to apply independence requirements to assurance engagements, and the implementation of the new IFAC code of ethics. The CCAB has also issued ethical dilemma case studies for

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[148] www.ccab.org.uk/objectives.php.

professional accountants in business and professional accountants working as non-executive directors.

The role of audit committees

Legal provisions

233. The Companies Act[149] defines 'audit committee' as meaning a body which performs the functions referred to in Article 41.2 of the Audit Directive[150] or equivalent functions.

234. Article 41.2 of the Audit Directive requires every public interest entity to have an audit committee, which has at least four functions:

(a) to monitor the financial reporting process;

(b) to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;

(c) to monitor the statutory audit of the annual and consolidated accounts; and

(d) to review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

235. The Company Reporting Directive[151] requires companies whose securities are traded on a regulated market to include a corporate governance statement in their annual report.

236. As the UK already had self-regulatory arrangements for ACs in the Combined Code on Corporate Governance (from 2010 revised and renamed *The UK Corporate Governance Code*) these EU requirements were given effect by amending Part 6 of

[149] Schedule 10, paragraph 10B of the Companies Act (inserted by Statutory Auditors and Third Country Auditors Regulations 2007 SI 2007/3494, regulation 21).
[150] Directive 2006/43/EC.
[151] Directive 2006/46/EC.

the Financial Services and Markets Act 2000 to allow the FSA to make rules as to 'any Community obligation relating to the corporate governance of issuers'.[152]

237. Accordingly, the arrangements for ACs are treated as being part of corporate governance and transparency matters, and the requirements of EU Directives have been given effect under the Financial Markets and Securities Act as issuer matters, not as company matters, and are not treated as 'company law provisions' for the purposes of the Companies Act.[153]

Development of corporate governance provisions relating to audit committees

238. ACs were first proposed by the Cadbury Report on corporate governance in 1992.[154] Since 1994, the London Stock Exchange Listing Rules[155] have required companies that do not have an AC to explain to the stock market why they do not have one.

239. In 1998, the Hampel report reviewed and revised the Cadbury and Greenbury reports.[156] It proposed principles of good governance rather than explicit rules, in order to reduce the regulatory burden on companies and avoid 'box ticking' so as to be flexible enough to be applicable to all companies. Indeed, a key feature of the UK corporate governance framework is the Listing Rules requirement that companies disclose the extent of compliance with the Code and explains any non-compliance (this is the so-called 'comply or explain' approach).

240. In 1998, the Combined Code on Corporate Governance was created to consolidate the principles and recommendations of the Cadbury, Greenbury and Hampel reports.

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[152] Section 1269 of the Companies Act inserts a new section 89O into Part 6 of the Financial Services and Markets Companies Act 2000. The Secretary of State is also given a regulation-making power, similar to that of the FSA, by section 1273 of the Companies Act.
[153] Section 2 of the Companies Act limits the 'company law provisions of the Companies Act' to the provisions of Parts 1 to 39 and those in Parts 45 to 47. The sections relevant to audit committees are in Part 42 of the Companies Act.
[154] *Financial Aspects of Corporate Governance* (December 1992). The report recommended that companies should establish an Audit Committee, comprising at least three non-executives.
[155] In accordance with the Markets in Financial Instruments Directive 2004 (OJ (2004) L247/1) the LSE Listing Rules comply with the UK Listing Authority Rules.
[156] The Greenbury report (1995) led to a *Code of Best Practice on Directors' Remuneration*.

Compliance with the Code was not mandatory, but the Code was appended to the London Stock Exchange Listing Rules.

241. In 2003, the Smith report[157] developed and codified the role of ACs. It recommended that:

(a) ACs should include at least three members, all of them to be independent non-executive directors, and at least one of them to have significant, recent and relevant financial experience, with suitable training to be provided to all of them; and

(b) that the role of the ACs should be:

— to monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements;

— to review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;

— to monitor and review the effectiveness of the company's internal audit function;

— to make recommendations to the board in relation to the external auditor's appointment; and in the event of the board's rejecting the recommendation, the AC and the board should explain their respective positions in the annual report;

— to monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements; and

to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

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[157] The Smith report: *Audit committees: Combined Code guidance*, 2003.

242. These recommendations were incorporated into the Combined Code in 2003, which also required that the AC should be provided with sufficient resources, that its activities should be reported in a separate section of the directors' report (within the annual report) and that the ACC should be present to answer questions at the AGM. The Smith material was revised several times (2005, 2008, 2010), and in 2010, following a review by the FRC,[158] the code was renamed The UK Corporate Governance Code.

243. The FRC's Ethical Standards and ISAs (UK and Ireland) (published pre-reform by the APB) require that the company's statutory auditor must make a report to the AC that includes:

(a) a statement in writing confirming the person's independence from the public interest entity;

(b) a description of any services provided by the person to the public interest entity other than in his capacity as statutory auditor;

(c) a description of any significant threats to the person's independence;

(d) an explanation of the steps taken by the person to safeguard his independence from those threats;

(e) a description of any material weaknesses arising from the statutory audit in the public interest entity's internal control in relation to the preparation of accounts; and

(f) any other significant matters arising from the statutory audit.

244. The UK corporate governance regime is not static, and the Code has been regularly reviewed and updated since it was first released. In April 2012, the FRC launched a consultation[159] on proposed changes to the Code and ISAs, and published the

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[158] 2009 Review of the Combined Code.
[159] FRC, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees, April 2012.*

revised Code in September 2012. Extracts from the Code relevant to ACs and auditors are in Annex C to this appendix. The changes include a requirement for FTSE 350 companies to put the external audit out to tender at least once every ten years (on a comply or explain basis). In addition, the Code enhances the auditor's engagement with ACs, the role of ACs, and disclosure by ACs of the assessments they have made.

245. Further detail on the evolution of UK corporate governance is contained in Annex B to this appendix.

The role of shareholders with regard to audits

Rights in the Companies Act 2006

246. Part 16 of the Companies Act gives shareholders the right to 'hire and fire' the company's auditor; to receive the audit report; to require the company to publish on its website a statement setting out matters relating to the audit or circumstances connected with the auditor ceasing to hold office; and to authorize a liability limitation agreement with the auditor.

247. The shareholders have the right to appoint an auditor by ordinary resolution at an accounts meeting[160] and to determine the auditor's remuneration, or decide the method by which it should be determined.[161] The directors can appoint the company's first auditor (or the first after a period of audit exemption), and can fill a casual vacancy, in which case the directors fix the auditor's remuneration.

248. The shareholders have the right at any time to dismiss the company's auditor by ordinary resolution,[162] so long as special notice is given and any representations

[160] Section 489(4) of the Companies Act.
[161] Section 492(1) of the Companies Act.
[162] Section 510 of the Companies Act.

made by the auditor are sent to every member of the company who has notice of the meeting.[163]

249. The shareholders have the right to receive the auditor's report on whether, in the auditor's opinion, the accounts have been properly prepared and constitute a true and fair view of the state of the company's affairs, and whether the report is unqualified or qualified.[164] The report must include an introduction identifying the annual accounts and the financial reporting framework that has been applied in their preparation and a description of the scope of the audit, identifying the auditing standards that have been applied.

250. The members of a listed company have the right to require the company to publish on a website a statement setting out concerns relating to the audit, or any circumstances connected with an auditor of the company ceasing to hold office, that the members propose to raise at the next accounts meeting of the company. This right is conditional on the request being made by members representing at least 5 per cent of the total voting rights, or by at least 100 members who have a relevant right to vote and hold shares in the company on which there has been paid up an average sum per member of at least £100.

251. The members of the company have the right to authorize by resolution in a general meeting a liability limitation agreement which limits the liability owed to the company by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the course of the audit.[165]

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[163] Section 511 of the Companies Act.
[164] Section 495 of the Companies Act.
[165] Section 536 of the Companies Act.

The Stewardship Code

252. The Stewardship Code was published in July 2010 by the FRC. The FRC has stated that it aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities by setting out good practice on engagement with investee companies to which the FRC believes institutional investors should aspire. It appears relevant to the audit investigation to the extent that institutional investors have a right to vote on the appointment of auditors.

253. The Stewardship Code is a set of principles and guidelines. Its principal aim is to make shareholders be active and engage in corporate governance in the interests of their beneficiaries. It is addressed in the first instance to firms which manage assets on behalf of institutional shareholders (such as pension funds, insurance companies, and investment trusts), but the FRC has stated that the responsibility for monitoring company performance does not rest with fund managers alone, and thus encourages other institutional investors to disclose their level of compliance with the Stewardship Code.

254. The FRC sees the Stewardship Code as complementary to the Code (see paragraph 158) and, like the Code, should be applied on a 'comply or explain' basis. This means that it does not require compliance with the principles, but if fund managers and institutional investors do not comply with any of the principles set out, they must explain why they have not done so. The information is also sent to the FRC.

255. There are seven principles of the Stewardship Code: (1) publicly disclose their policy on how they will discharge their stewardship responsibilities; (2) have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed; (3) monitor their investee companies; (4) establish clear guidelines

on when and how they will escalate their activities as a method of protecting and enhancing shareholder value; (5) be willing to act collectively with other investors where appropriate; (6) have a clear policy on voting and disclosure of voting activity; and (7) report periodically on their stewardship and voting activities.

Audit-related services contained in Ethical Standard 5

Audit-related services are:

- reporting required by law or regulation to be provided by the auditor;
- reviews of interim financial information;
- reporting on regulatory returns;
- reporting to a regulator on client assets;
- reporting on government grants;
- reporting on internal financial controls when required by law or regulation; and
- extended audit work that is authorized by those charged with governance performed on financial information[166] and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions.

[166] This does not include accounting services.

Reports and reviews leading up to the current Code

1992—Cadbury Report

1. The Cadbury Report[167] was published in 1992 and was a response to major corporate scandals associated with corporate governance failures in the UK in the late 1980s/early 1990s: Polly Peck, BCCI and Maxwell. The report covered financial, auditing and corporate governance matters, including seven pages of guidance for ACs in the appendices to the report, and made 18 recommendations, including the following:

   (a) the CEO and chairman of companies should be separated;

   (b) Boards should have at least three non-executive directors, two of whom should have no financial or personal ties to directors;

   (c) each board should have an audit committee composed of non-executive directors; and

   (d) directors should report on the effectiveness of the company's system of internal control.

2. In 1994, these recommendations were appended to the Listing Rules of the London Stock Exchange. It was stipulated that companies need not comply with the rules, but had to explain to the stock market why not if they did not. This is still the case—what the Code refers to as 'comply or explain' (see paragraph 239).

[167] *Financial Aspects of Corporate Governance*, December 1992: www.ecgi.org/codes/documents/cadbury.pdf.

1995—Greenbury Report

3. Following public anger over executive pay, particularly in the then recently privatized public utilities, the Greenbury Report[168] recommended some additions to the existing principles in the Cadbury Report:

   (a) Each board should have a remuneration committee composed without executive directors, but possibly the chairman.

   (b) Directors should have long-term performance-related pay, which should be disclosed in the accounts and contracts renewable each year.

   (c) All kinds of remuneration including pensions should be disclosed.

1998—Hampel Report

4. In 1998 the Hampel Report,[169] intended to be a progress review three years after the Greenbury Report was the genesis of the Combined Code, suggesting that all the Cadbury and Greenbury principles be consolidated into a 'Combined Code'. It added a large number of new provisions, including:

   (a) The Chairman of the board should be seen as the 'leader' of the non-executive directors.

   (b) Institutional investors should consider voting with the shares they held at meetings, though rejected compulsory voting.

1999—Turnbull Report

5. The Turnbull Report[170] was published one year after the Hampel Report, and recommended that directors be responsible for financial and auditing controls.

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[168] *Directors' Remuneration, Report of the Study Group*: www.ecgi.org/codes/code.php?code_id=131.
[169] *Review of Corporate Governance since Cadbury*: www.ecgi.org/codes/documents/hampel.pdf.
[170] *Internal Control: Guidance for Directors on the Combined Code*.

2001—Myners Report

256. The Myners Report[171] was published to HM Treasury in March 2001 (and a review in 2003[172]) on the role of institutional investors, in particular whether there were factors distorting the investment decision-making of institutions. The Report identified a number of distortions in investment decisions. Key decision-makers did not always have the skills, expertise and information to carry out their responsibilities effectively. Lack of clarity about decision-making structures and incentives caused the misalignment of the objectives of the ultimate investors—the millions of consumers and pension fund members—and the agents investing on their behalf.

2009—Walker Review

257. The Walker Review[173] was published in 2009 shortly after the collapse of Northern Rock and the financial crisis, focusing on the banking industry, but also with recommendations for all companies. These included that the remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as the Stewardship Code. A further recommendation was that the board of a FTSE 100-listed bank or life insurance company should establish a board risk committee separately from the AC. The board risk committee should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management, and the embedding and maintenance throughout

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[171] *Institutional Investment in the United Kingdom: A Review*: http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf.
[172] *Myners principles for institutional investment decision-making: review of progress*: www.hm-treasury.gov.uk/d/myners_principles_web.pdf.
[173] *A review of corporate governance in UK banks and other financial industry entities: Final recommendations*: .http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

the entity of a supportive culture in relation to the management of risk alongside established prescriptive rules and procedures.

Code (September 2012) provisions for Audit Committee and Auditors—extracts

Main Principle

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.

Code Provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and

removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;

- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and
- to report to the board on how it has discharged its responsibilities.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. [The requirement to make the information available would be met by including the information on a website that is maintained by or on behalf of the company.]

C.3.4 Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

C.3.5 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.6 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.7 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.8 A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted; and
- if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.

Audit Choice Market Participants Report, October 2007: list of recommendations

1. The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.

2. Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.

3. In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.

4. Regulatory organizations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.

5. The FRC should continue its efforts to promote understanding of audit quality and the firms and the FRC should promote greater transparency of the capabilities of individual firms.

6. The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.

7. The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.

8. The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.

9. When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.

10. Investor groups, corporate representatives, auditors and the FRC should promote good practices for shareholder engagement on auditor appointments and re-appointments.

11. Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.

12. The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.

13. Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.

14. Every firm that audits public interest entities should comply with the provisions of a Combined-Code-style best practice corporate governance guide or give a considered explanation.

15. Major PIE should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

The suppliers of statutory audit services to large companies

1. This appendix provides a brief description of each of the nine largest firms which have provided statutory audit services to large[1] listed companies in the UK: Baker Tilly,[2] BDO, Deloitte, EY, GT, KPMG, Mazars, PKF and PwC.

Baker Tilly

History

2. Baker Tilly was formed in 1988 on the merger of Baker Rooke, and Howard, Tilly & Co, with the two predecessor firms tracing their respective roots to firms established in 1901 and 1865 respectively. It subsequently merged with a number of smaller firms in the 1990s and 2000s and, as a consequence of one of those mergers (with Casson Beckman in 1997), joined its current network (then known as Summit International but subsequently rebranded as Baker Tilly International in 2002).

3. Between 2002 and 2011, the Baker Tilly International network increased in size significantly, increasing the number of countries it operates in from 59 to 125, through identifying 42 new firms to become members, and increasing network revenue from $1.4 billion to $3.2 billion.

Legal and operational structure

4. Since 2007, Baker Tilly has operated through a group of companies limited by shares and LLPs, of which Baker Tilly UK Holdings Ltd is the ultimate holding company. Baker Tilly UK Holdings Ltd is owned by a number of shareholders, who are either current or former partners of Baker Tilly and its subsidiary LLPs.

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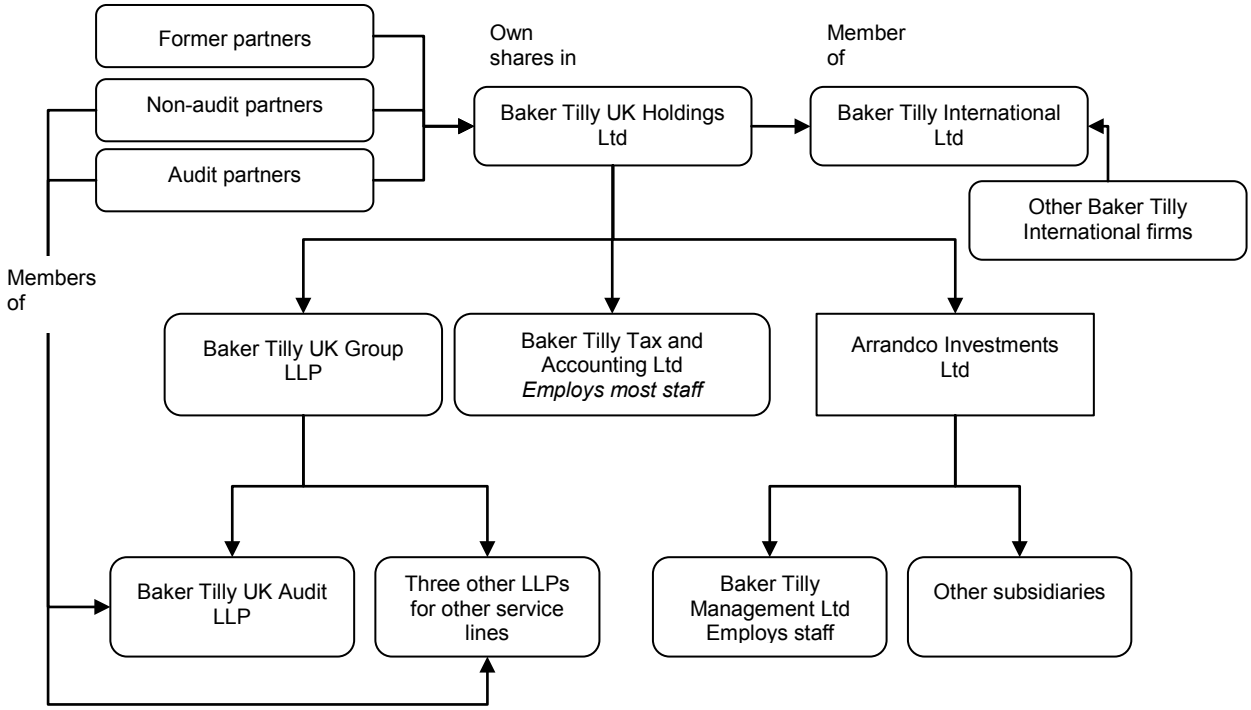
[1] By 'large' in this context we are including a wider group of companies than just FTSE 350 companies (Mazars has not audited a FTSE 350 company in the last five years) and we are not using the definition of large companies set out in our terms of reference.
[2] Statutory audit services are provided by Baker Tilly UK Audit LLP, which is part of the Baker Tilly group.

5. The business of Baker Tilly is divided into four main service lines, each of which is delivered through a separate legal entity as follows: Audit and Assurance (Baker Tilly UK Audit LLP), Corporate Finance (Baker Tilly Corporate Finance LLP), Restructuring and Recovery (Baker Tilly Restructuring and Recovery LLP) and Tax and Accounting (Baker Tilly Tax and Accounting Ltd/Baker Tilly Tax and Advisory Services LLP). The partners involved in the delivery of each service line are members of the relevant LLP(s). An intermediate holding entity, Baker Tilly UK Group LLP, is also a member of each of the LLPs.

FIGURE 1

Organizational structure of Baker Tilly



Source: Baker Tilly UK Transparency Report.

6. The Baker Tilly network body is Baker Tilly International Ltd, which is a UK company limited by guarantee. The staff of Baker Tilly UK are predominantly employed through Baker Tilly Tax and Accounting Ltd.

7. The governance of Baker Tilly UK is structured as follows:

(a) The Managing Director of Baker Tilly UK Holdings Ltd is appointed by the shareholders and appoints the remainder of the board. The board of Baker Tilly UK Holdings Ltd appoints the National Management Team (NMT) of Baker Tilly UK Group LLP.

(b) NMT is responsible for setting the group's overall strategy and driving it forward.

(c) The Baker Tilly UK Audit LLP Management Board is the specific management body responsible for the management and governance of the audit practice. Members of the Management Board are elected by the individual members of Baker Tilly UK Audit LLP with the prior approval of the corporate member (Baker Tilly UK Group LLP). There is an Audit Management Team that reports into the Management Board.

8. The Baker Tilly International network is managed through the following structures:

(a) The International Board of Directors is composed of 15 elected directors, who are elected from the senior partners of the member firms. The board sets the network body's strategy and policies. The board chooses a Chair from its members.

(b) The Chief Executive Officer and President (CEO) is responsible for managing the Baker Tilly network on a day-to-day basis and is supported by a Chief Operating Officer and the staff employed by Baker Tilly International Ltd.

(c) Regional Chairs. The network is managed as four regions, with the CEO appointing a Chair for each region, responsible for managing relations between firms in that area.

9. The network is funded through three sets of charges: a fee on joining; an annual fee based on firm revenue; and a fee based on the level of referred fees a member has benefited from as a result of membership of the network.

UK firm revenues

10. Baker Tilly's UK revenue in 2010/11 was £179 million and was generated through the following services:

    (a) Audit and assurance (34 per cent);

    (b) Corporate finance (8 per cent);

    (c) Restructuring and recovery (17 per cent); and

    (d) Tax and accounting (41 per cent).

BDO

History

11. The BDO network was established in 1963 when independent firms from the UK, Netherlands, Germany, USA and Canada formed an alliance to service their international clients. The network was initially known as Binder Seidman International, and changed its name in 1973 to BDO (Binder Dijker Otte & Co). The founding UK member firm was Binder Hamlyn, which itself was established in 1918.[3]

12. In 1994, Arthur Andersen UK acquired seven of Binder Hamlyn's UK offices to expand its UK client base, with these offices continuing to trade as Binder Hamlyn in the UK until 2002, when they rebranded as Arthur Andersen.[4] The rest of Binder Hamlyn fractured, with 13 of the remaining offices and half of the Bristol office joining Stoy Hayward.[5] Stoy Hayward then assumed the position of UK member firm of the BDO network.

13. Stoy Hayward was established in 1903 by AF Stoy as Stoy & Co and became Stoy Hayward & Co in 1919, and then Stoy Hayward in 1988. In 1994, prior to its acquisition of the Binder Hamlyn offices, the firm expanded by merging with Finnie &

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[3] www.bdocareers.co.uk/page.aspx/BDO-History.
[4] On the collapse of Arthur Andersen in the USA, Andersen UK merged with Deloitte.
[5] The Birmingham office and the other half of the Bristol office joined Touche Ross. Two further offices joined GT.

Co. In 2009, the firm (along with all members of the BDO network) renamed itself to BDO to create a single international brand.

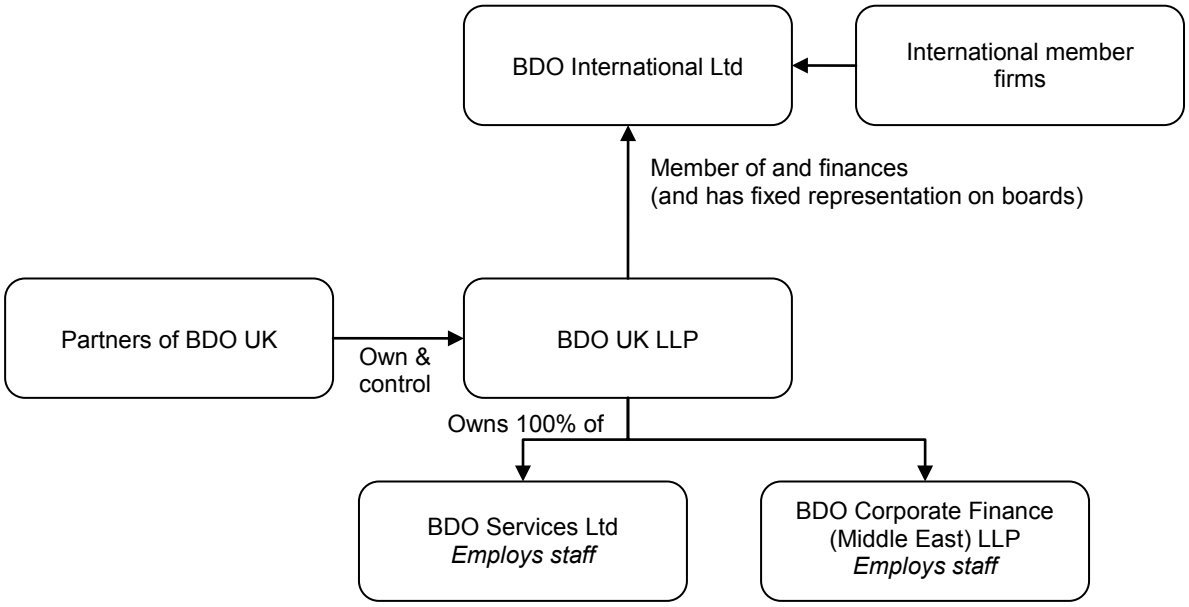
14. Prior to joining the BDO network, Stoy Hayward had been the UK member firm of the Horwath network and its departure left the Horwath network without a UK member firm, which in turn led the smaller firm Clark Whitehill to join the Horwath network.[6]

Legal and operational structure

15. BDO is a limited liability partnership and is the UK member of the BDO network, which is legally structured on membership of BDO International Ltd. Arrangements with the network are discussed below (see paragraph 20). BDO operates in Great Britain and licenses an independent partnership to trade using the name BDO Northern Ireland in Northern Ireland.

FIGURE 2

Ownership and structure of BDO UK



Source: Analysis of BDO Transparency Report and annual report.

[6] www.accountingweb.co.uk/sites/default/files/siftmedia-accountingweb/old_downloads/accounting_brand_value.pdf.

16. The staff of the firm are employed through a subsidiary, BDO Services Ltd. The firm has overseas operations through a wholly-owned subsidiary that provides corporate finance advice in the Middle East.

17. BDO partners do not have direct voting control over the decisions of the network; rather the UK has the right to a seat on a number of the network's governance committees, with the UK firm choosing its representative. This is discussed in more detail below from paragraph 20.

18. BDO is managed on the basis of geographic location of clients and its three service lines (Audit, Advisory and Tax).

19. The governance structures of BDO are as follows:

(a) The Managing Partner is elected by the partnership as whole for a term of four years. The Managing Partner is responsible for appointing a leadership team.

(b) The Senior Partner is elected by the partnership to act as a figurehead for the firm and to oversee corporate governance.

(c) The Leadership team (LT) is appointed by the Managing Partner and approved by the Partnership Council. The LT meets monthly and is responsible for the strategic and operational leadership of the firm. It also includes two independent, non-executive members who have the ability to consult the Partnership Council.

(d) The Partnership Council represents the interests of the partnership, including admissions to the partnership and remuneration and profit-sharing arrangements. It is composed of the Managing Partner, Senior Partner and another representative of the LT and has 12 members elected by the partnership and meets monthly. It is also responsible for approving the appointment of the leadership team and independent non-executives.

Relationship with network

20. BDO describes itself as the fifth largest global professional services network, with 48,800 staff in 1,118 offices in 135 countries.[7] BDO International Ltd, a UK company limited by guarantee, is the network body. Services to the network and member firms are provided through Brussels Worldwide Services BVBA (a Belgian private limited company). The trademark of BDO is owned by Stichting BDO, a 'Dutch Foundation', whilst use of the trademark and the network's intellectual property (such as methodology and software) is licensed by BDO IP Ltd, a company registered in Bermuda.

21. Membership of the network is through membership of BDO International Ltd, as either a voting or non-voting member.[8]

22. In addition to having full member firms, member firms can also enter into 'alliances' in their local territories with other firms. For example in Spain and the USA other independent firms are used to increase the capacity of the BDO member firm to undertake work.[9]

23. The principal governance structures of the network are:

    (a) The Council, which meets annually to approve budgets and any changes to the operation of the network, and appoints the Policy Board. Its membership is drawn from one representative from each voting member of BDO International Ltd.

    (b) The Policy Board acts as a Board of Directors and sets policies and priorities for the network and supervises the Global Leadership Team. It is composed of one member from each of the five largest member firms. It elects the CEO and meets at least quarterly.

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[7] www.bdointernational.com/AboutUs/Pages/default.aspx.
[8] Non-voting membership is necessary where in a given country a firm is composed of separate legal entities; one entity will have voting rights, the rest do not.
[9] www.cpaadmin.org/pdfs/firm_affiliations/BDOSeidmanAllianceBringingMoreToClients.pdf.

(c) The Global Leadership Team is led by a CEO and a number of executives (including Global Heads of Audit and accounting, and Tax). Membership is chosen by the CEO and it meets monthly.

24. The UK firm is the largest employer by number of staff in the network with 7 per cent of the combined total of staff employed by member firms.

UK firm revenues

25. UK Revenues from BDO's service lines in 2011 were:

(a) Audit—£91 million (31 per cent of firm revenue);

(b) Advisory, comprising:

(i) Business Restructuring—£42 million (14 per cent);

(ii) Corporate Finance—£34 million (12 per cent); and

(iii) Forensic Services—£36 million (12 per cent); and

(c) Tax—£80 million (28 per cent).[10]

26. Statutory audit has accounted for [✂] per cent of the firm's revenue since 2004. In BDO's 2011 Transparency Report, BDO stated that 31.3 per cent of firm revenues were from statutory audit, with an additional 17 per cent from non-audit services provided to audit clients.

27. Table 1 summarizes the sources of statutory income for BDO.

TABLE 1 **BDO UK revenue from statutory audit**

[✂]

Source: BDO

[10] BDO Transparency Report July 2011. Includes the Belfast firm of BDO which is a licensee of BDO UK.

Other

28. On 7 November 2012, BDO and PKF announced that they intend to merge.

Deloitte

History

29. The present Deloitte network was created on the merger of the networks of Deloitte, Haskins & Sells and Touche Ross in 1989, which was initiated by the US member firms.[11] Both of the previous networks had developed from two UK firms that had been established in the 19th century (one founded by William Welch Deloitte in 1845 and the other by George Touche in 1898) which had opened offices in the USA by the turn of the 20th century.[12]

30. Both networks had grown through a number of arrangements and alliances with other firms, most notably the US merger of Deloitte Plender Griffiths & Company with Haskins & Sells in 1952 which followed on from a 'co-partnership' established in 1925, which operated in a number of countries under the name Deloitte, Plender, Haskins & Sells.[13]

31. The UK member firm of the present day Deloitte network is the continuation of the original UK Touche Ross firm and has no link with the original UK practice of Deloitte Haskins & Sells. As noted, the 1989 merger of the Deloitte Haskins & Sells and Touche Ross networks had been instigated by the US firms, and while the majority of international member firms chose to merge in their respective territories (most likely because of the size of the US firms), Deloitte Haskins & Sells in the UK declined and instead negotiated a merger with the UK firm of Coopers & Lybrand, leaving Touche

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[11] On merger, the network was known as DRT, and subsequently changed name when it was legally free to use the name Deloitte.
[12] Office is used to describe the initial expansion overseas, based on terminology used in sources.
[13] www.deloitte.com/view/en_GX/global/about/overview/history/index.htm.

Ross UK as the UK member firm of the newly enlarged Deloitte & Touche network (at the time known as DRT International).

32. Since a number of Deloitte network member firms had not merged with their local Touche Ross firm, it was not immediately possible for the new network to use the name Deloitte, and was forced as an interim measure to refer to the network as 'DRT'. In 1993, the network was able to readopt the Deloitte name and the network became known as Deloitte Touche Tohmatsu, and subsequently has traded as Deloitte in the UK.

33. In 2002, the UK firm of Deloitte & Touche acquired some of the assets, partners and staff of Arthur Andersen after initial negotiations between Arthur Andersen and KPMG failed. This transaction was subject to EC merger control, and the EC allowed the transaction on the basis that the UK firm of Arthur Andersen was economically separate from other members of the network.[14]

Legal and operational structure

34. Deloitte Touche Tohmatsu Limited (DTTL), the network entity, is a company limited by guarantee, incorporated in the UK.[15] The UK member of the network is Deloitte. As an LLP, Deloitte is owned by its members (partners), who retain control of the firm. Its corporate structure is similar to the other large firms, with a series of subsidiaries that employ the LLP's staff and act as operating companies for the different service lines.[16,17] Figure 3 provides a simplified overview of Deloitte's legal structure.

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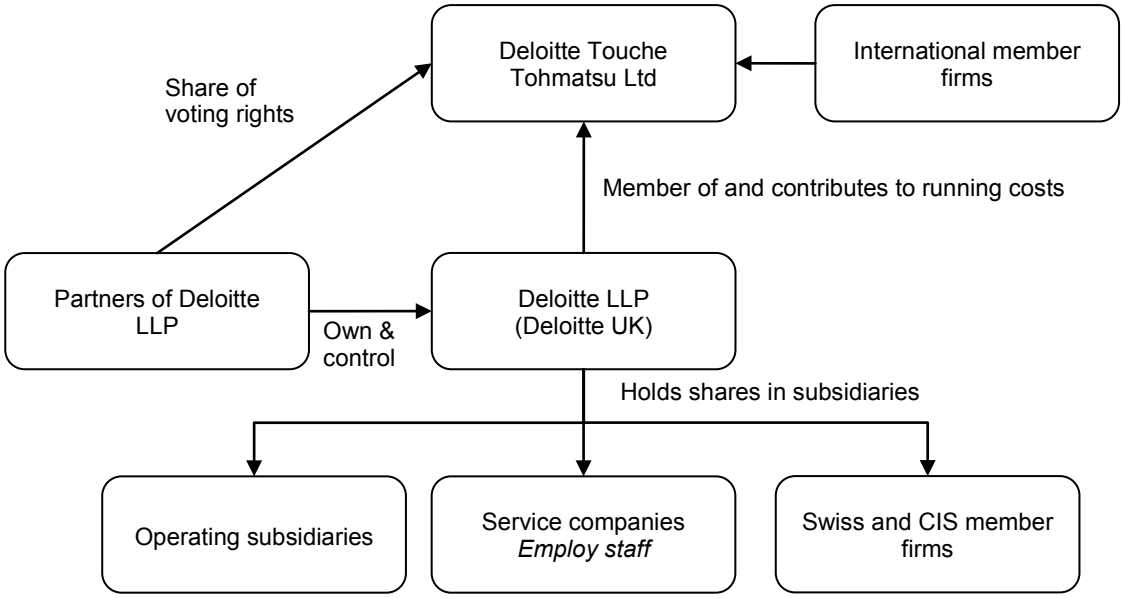
[14] Case No COMP/M.2810. Andersen's corporate restructuring and legal practices did not merge with Deloitte.
[15] Prior to 2010, the network was structured as a Swiss verein, which is an unincorporated association (intended for use by sports clubs etc).
[16] A special purpose vehicle is a subsidiary created for a specific purpose, in this case, the partnership does not employ any staff. Any professional services engagement can be between either the LLP or one of its subsidiaries. By creating a subsidiary, the LLP is protected from financial risk as it is only the subsidiary that legal action can be taken against.
[17] One new avenue for increasing the non-audit business has been Ingeus UK Ltd, a joint venture with Ingeus International to run part of the Government's Work Programme.

FIGURE 3

Ownership of Deloitte LLP



Source: CC analysis of financial statements and material provided by Deloitte.

35. As a member of DTTL, Deloitte has voting rights in DTTL. The membership of the DTTL board is determined through an allocation of seats to member firms, based on size, revenue, geography and client base, with each firm choosing its own representatives. The arrangements of the network are established by an agreement between each member firm and DTTL. The governance arrangements of DTTL are discussed in paragraph 42.

36. Deloitte is relatively unusual in that it controls other European member firms of the network. The firm has subsidiary operations in Switzerland providing a full range of professional services. In addition, it has a strategic investment in Deloitte CIS (Commonwealth of Independent States), through Deloitte CIS Limited, a UK holding company.[18] Deloitte provides professional support to the Deloitte CIS member firm.

[18] Deloitte CIS Ltd is a holding company and was incorporated in 2010.

Deloitte is a partner in a joint venture which provides corporate finance services in the Middle East.

37. Management of the UK firm is based on a matrix structure with the business divided into:

(a) industries;

(b) service lines (see paragraph 51 below); and

(c) geographies (regions, Switzerland).

38. The firm is managed on a day-to-day basis by the Senior Partner and CEO and supported by the Executive group, which is appointed by the CEO. The Executive group is responsible for implementing policies and strategies decided by the board and planning the firm's future development.

39. Overall oversight is through the Board of Partners which 'promotes and protects partners' interests' and approves long-term strategy. Both the Chairman and CEO are elected by the partners of the firm and they attend the board with ten elected partners, three independent non-executives and three partners from the Executive group. The board has oversight of risk and quality in the firm.

40. Subcommittees of the board have been established for specific oversight of compensation, remuneration, nomination and public interest issues. No members of the Executive group sit on these committees. Additionally there is an audit committee with at least three non-executive board members who are not also members of the Executive group.

41. Delivery of audit services (including various assurance activities) is overseen by the Managing Partner Audit, supported by the Audit Executive. The Audit Executive

meets monthly and is composed of representatives from the different areas of the audit service line.

Relationship with network

42. The member firms of the DTTL network operate in 153 countries and are supported by DTTL, which has a number of governance structures:

(a) The Board of Directors (DTTL Board) is the highest governing body in the network and approves the policy and strategy of the network. It is led by the DTTL Chairman and has 32 board members including the CEO. Member firms and regions are allocated a number of seats on the board based on the size, revenue, geography and client base of those firms. Representatives of each member firm are chosen by that member firm's partners. Three seats are allocated to regions to allow a representation of smaller firms.

(b) The DTTL Governance Committee (a subcommittee of the DTTL Board) includes representatives from the largest member firms and the CEO and has oversight responsibility for DTTL's management and focuses particularly on 'major strategic issues facing DTTL and the member firms'.

(c) The DTTL CEO is approved by the DTTL Board, subject to two-thirds of the partners of member firms participating in a ratification vote with a requirement that 50 per cent of the partners must participate for the vote to be valid. The CEO serves a four-year term with a limit of two terms.

(d) The DTTL Executive is led by the DTTL CEO. There are 19 members of the DTTL Executive (plus two ex officio members) who are chosen by the CEO, subject to approval of the Governance Committee of the DTTL Board. Its

responsibilities include 'fostering a common vision and helping to develop and direct DTTL's strategies'.[19]

43. The voting rights of member firms are determined by two factors: revenue and professional headcount (with each having an equal rating). Deloitte holds approximately 10 per cent of the voting rights in the network.

44. The Deloitte Transparency Report states that the function of DTTL is: 'to coordinate [member firms'] approach to client service, professional standards, shared values, methodologies, and systems of quality control and risk management.'[20]

45. DTTL manages the international brand and puts in place policies for member firms to ensure consistency (such as audit methodology), but implementation of policies is controlled at a member firm level.

46. The current Chairman of the DTTL Board is Steve Almond, Managing Partner for Deloitte's International Markets, who succeeded John Connolly, the former UK Senior Partner in this role. The DTTL Executive is headed by the DTTL CEO, Barry Salzberg, who is the former CEO of Deloitte USA.

47. Deloitte's financial contribution to the DTTL network since 2007 has been in the order of 2.3 to 2.4 per cent of net revenue each year.[21]

48. DTTL does not directly incur any expenditure; rather it is supported by another company, Deloitte Global Services Ltd (DGS), which provides services to the

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[19] Deloitte UK 2011 Transparency Report, p22.
[20] Deloitte UK 2011 Transparency Report.
[21] Commentary accompanying Deloitte's management accounts indicate that the contribution is linked to revenue.

member firms.[22] DGS recorded revenue from membership fees of $532 million (approx: £337 million) in FY 2011 with an additional $197m (approx: £125 million) of additional direct charges to member firms. There is also a US company Deloitte Touche Tohmatsu Services Inc, which provides services to some member firms (and charges DGS a management fee of approximately $21 million (approx: £13 million)). Staff costs of running the network were $113 million (approx: £71 million).

49. DGS's financial statements show that there are outstanding loans of some $95 million (approximately: £61 million) made to member firms, with interest charged at DGS's own borrowing rate.

50. DGS is also responsible for developing the network's technology platform and holds an asset with a carrying value of $97 million (approximately: £62 million) relating to software development and in 2011 spent $32 million (approximately: £21 million) on development costs for software of which $14 million (approximately: £9 million) was not capitalized.[23]

UK firm revenues

51. Deloitte's UK gross revenue in FY 2011 from all service lines was £2,098 million.[24] The firm structures its business into four service lines which in FY 2011 generated the following levels of revenue:

(a) Audit (31 per cent of revenue);

(b) Tax (25 per cent of revenue);

(c) Consultancy (25 per cent of revenue); and

(d) Corporate Finance (19 per cent of revenue).[25]

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[22] Prior to 2010 this activity was undertaken by a Swiss verein.
[23] Capitalization is the recognition of an asset on the balance sheet. Not all costs of developing an asset can be capitalized, because they are not directly related to the use of final asset (such as research costs).
[24] Includes Swiss revenues.

52. Audit and directly related services accounted for 24 per cent of total gross revenue in 2011.[26] Non-audit work for audit clients generated 9 per cent of revenue, with the remaining 67 per cent relating to non-audit clients. This was at a similar level in 2010 and 2009.[27] This indicates that 33 per cent of total revenue came from audit clients.

53. Table 2 summarizes the sources of audit and directly related services net revenue for Deloitte.

TABLE 2 **Deloitte revenue from statutory audit**

£'000

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
FTSE 100			[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
FTSE 250			[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: Deloitte.

Note: Deloitte has not been able to produce data for 2004 and 2005.

EY

History

54. The EY network was created in 1989 on the merger of two of the 'Big 8' networks, Ernst & Whinney and Arthur Young. Both Arthur Young and Ernst & Ernst (one of the two founding firms of Ernst & Whinney) were established in the USA in the 1900s.

55. In the UK, Ernst & Whinney was formed in 1979 by the merger of Ernst & Ernst (established 1903) and the UK firm of Whinney, Smith & Whinney (a successor partnership to one founded in 1849).[28] The two networks had worked with each other previously; Whinney had opened a New York office in 1914, solely for the purpose of servicing the Midland Bank which was increasing the level of its engagement with US

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[25] Deloitte initial submission.
[26] Deloitte 2011 Transparency Report.
[27] Deloitte, 2009, 2010 and 2011 Transparency Reports.
[28] The partnership changed its name several times and successor and predecessor firms are hereafter referred to as Whinney for simplicity.

banks (an example of client-driven expansion).[29] The office closed in 1917 as an impact of the First World War, and Ernst & Ernst was approached in 1918 to undertake this work on behalf of Whinney.

56. A formal alliance was made between Ernst & Ernst and Whinney in 1924 and led to Whinney representing Ernst & Ernst in Europe.[30] Whinney's growth in the UK in the interwar years was driven by work performed for American clients introduced to it as a result of its arrangement with Ernst & Ernst. This relationship continued to develop with cross-partnership agreements until the international partnership was formed in 1979.[31]

57. Similarly, Arthur Young entered into a formal alliance with the UK firm of Broads Paterson & Co in 1924 with a full amalgamation of the two firms in 1966. The 1924 alliance appears to have been based on Broads Paterson & Co supervising a 'branch office' for Arthur Young in the UK. As with Ernst and Whinney, the relationship between Broads Paterson & Co and Arthur Young predated the formal arrangement, extending back to 1904, when the two firms had undertaken a joint audit of one of Broads Paterson's clients.

Legal and operational structure

58. EY is a LLP, owned by its members (the partnership). EY is a subsidiary of a European entity, EY Europe LLP, which was created in conjunction with the Europe, Middle East, India and Africa (EMEIA) area in 2008 (see paragraph 63 below). The UK partners have exchanged their voting control of EY for a share of the voting rights of EY Europe LLP. As a result, EY is effectively operated as part of EY's European

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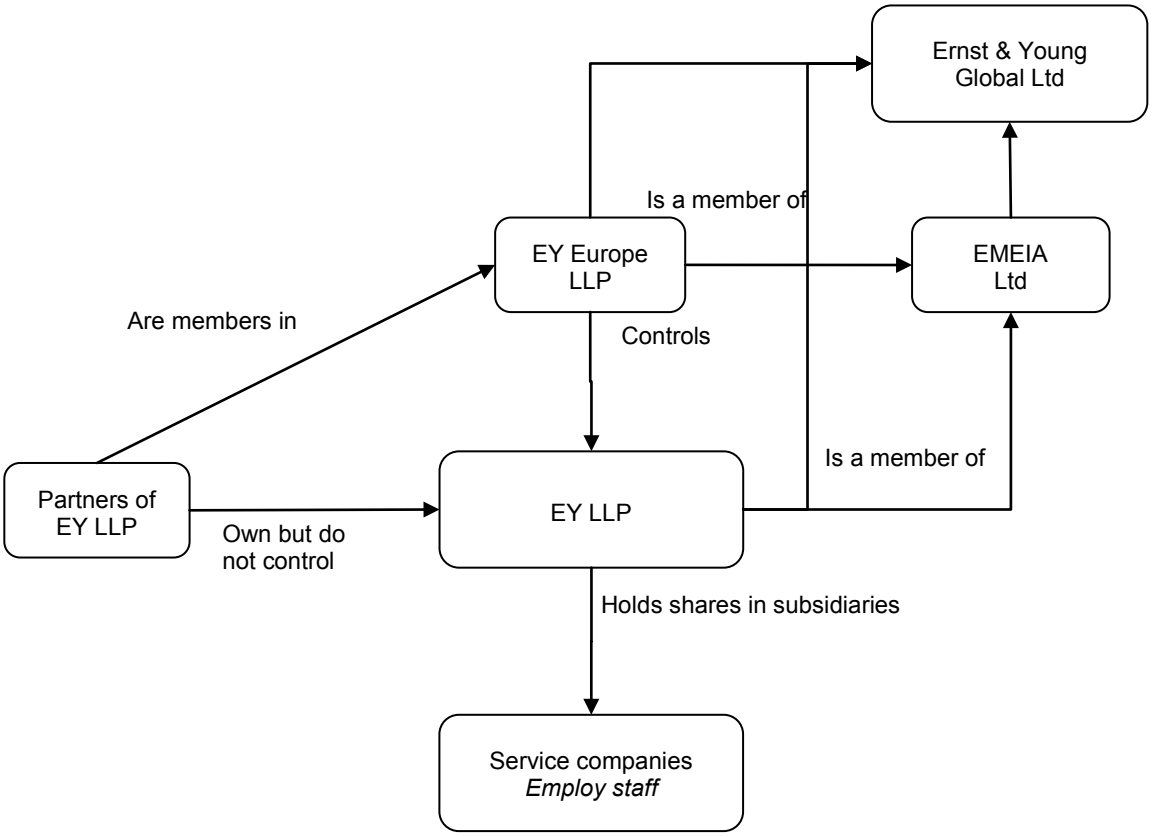
[29] Boys, P 'The origins and evolution of the accounting profession' in Habgood, W (ed), *Chartered Accountants in England and Wales: a guide to historical records,* p34.
[30] www.ey.com/US/en/About-us/Our-history/About-us-Our-history-timeline.
[31] Boys, P, op cit.

network. The structure and governance of EY and the EY network more generally is discussed below.

59. EY owns a number of subsidiary companies, most of which are dormant. Of the active subsidiaries, most are used for the purposes of employing the staff of EY.

FIGURE 4

EY ownership and legal structure



Source: CC analysis of financial statements and 'off the shelf' material.

60. There is a consistent management and governance structure at each of the Global and Area levels of the EY network including the European network firms and within the UK. Because of the nature of the EY network and the relationships the UK firm has within it, the UK governance structures should be considered alongside those at the European and Global elements levels of the organization.

61. Whilst a significant amount of control is retained at the European level, the UK firm retains its own board, appointed by the European Executive, and is responsible inter alia for the commercial, financial and reputational standing of the firm. The board is led by the Country Managing Partner (CMP), who is appointed (and can be replaced) by the European Managing Partner subject to European Executive approval.

62. The operational management of the UK firm is undertaken by two Sub-Area Managing Partners (SAMPs), who oversee two separate business divisions or sub areas, UK and Republic of Ireland (where the SAMP is also the CMP) and FSO (Financial Services Office) (discussed in the context of the network below).

Relationship with network

63. Ernst & Young Global Ltd (EYG) is the central governance entity of the EY network and coordinates the member firms and cooperation among them ('network firm'). EYG does not provide services to clients. EY is a member of EYG. EY organizes its network through four geographic areas: Americas, Asia-Pacific, Japan and EMEIA. The European area is overseen by EMEIA Ltd, which essentially acts as a second tier of network firms. EMEIA covers 93 countries, which are then managed as 12 sub areas. In the UK, there are two sub areas: UK and Republic of Ireland and FSO (Financial Services Office), each overseen by a SAMP.

64. The principal governance and management bodies of the global network are:

(a) The Global Executive led by the Chairman and Chief Executive and with representation from the four Area Managing Partners and the global heads of functions and service lines. With the Global Advisory Council, it approves nominations for Chairman, CEO and Chief Operating Officer of EYG and ratifies the appointment of Global Managing Partners.

(b) The Global Advisory Council is the main 'advisory body' for the network, which is composed of partners from across member firms who are elected for three-year terms. The Global Advisory Council is responsible for advising EYG on policy, strategy and the public interest aspect of decision making. The Global Advisory Council is required to ratify key decisions of EYG.[32] In September 2011, four Independent Non-Executives (INEs) were also appointed as members of the Advisory Council in line with the UK Audit Firm Governance Code.

(c) The Global Executive Committees are a number of service line and function committees that bring the four global areas together and cover operational matters.

(d) The Global Practice Group is composed of members of the Global Executive, Area service line and function leaders, and is responsible for ensuring consistency of execution of policy.

65. EYG does not directly incur expenditure. Services to clients are provided through the individual member firms. Services to the network are provided through EY Global Services LLP (EYGS LLP) and EY Global Services Ltd (EYGS Ltd) a wholly-owned subsidiary of EYGS LLP. Services to the European area are also provided by Ernst & Young (EMEIA) Services Ltd (EYES), which is also owned by EYGS LLP. These companies operate primarily from the UK.

66. In 2011, EYGS Ltd reported expenditure of £565 million with all expenditure re-charged to member firms in the financial year. £205 million of this was financed from payments from EYES. Expenditure incurred by the network is disclosed in its financial statements as:

(a) global technology—£362 million;

(b) industry and business development costs—£87 million; and

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[32] There are also a number of subcommittees of the EYG Executive.

(c) other operating costs—£117 million.[33]

67. EYGS Ltd holds £4 million in cash.

68. EYES incurred £635 million of expenditure. All expenditure is recovered from member firms in the EMEIA area. Expenditure incurred by EYES is disclosed as:

(a) charges by EYGS LLP—£183 million;

(b) purchased services—£130 million;

(c) technology—£204 million;

(d) practice and market development—£68 million; and

(e) other costs—£50 million.

69. The figure for purchased services relates to costs incurred by member firms on behalf of the company (largely seconded staff costs). EYES received £360,000 in interest charges from a loan to the subsidiary of a member firm (CE IT Services GmbH). EYES holds £77 million in cash as at 1 July 2011.

70. A review of the financial statements of EYGS LLP found that in 2011 EYGS changed from having a revolving credit facility of $450 million with a consortium of four banks to a similar facility with EY Global Finance Inc (EYGF), a US company, which is owned by member firms. Prior to the switch in facility, EYGS LLP had a bank loan of £168 million outstanding and loans from three unnamed member firms of £51 million.

71. EYGS LLP has another subsidiary, which provides services to the Asia-Pacific area which was not trading for all of 2011.

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[33] Other operating costs includes desktop and software maintenance, infrastructure, knowledge, procurement and transformation. No further information is provided.

UK firm revenues

72. EY provides services to its clients through four service lines (see Table 3), which are the same in each of the international member firms:

(a) Assurance—[✂] per cent of revenue. This includes accounting and financial reporting, audit, financial accounting advisory, and fraud investigation.

(b) Advisory—[✂] per cent of revenue. This includes risk, performance management and, IT risk and assurance.

(c) Tax—[✂] per cent of revenue. This includes direct and indirect tax, and human resource services.

(d) Transaction Advisory services—[✂] per cent of revenue. This includes restructuring, transaction tax advice and valuation and modelling.

73. Table 3 provides detail of the trend in statutory audit revenue. The table indicates that [✂].

TABLE 3 **EY UK revenues from statutory audit**

£'000

	2005	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
FTSE 100	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
FTSE 250	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: EY

GT

History

74. The UK member firm of GT traces its history to the firm Thornton Baker, which was formed in 1959 through the merger of two firms, Thornton & Thornton (established

1904) and Baker & Co (established 1868). Between 1959 and 1986, Thornton Baker grew through mergers with 50 other firms.[34]

75. In 1980 a new expanded network, including both Alexander Grant & Co, a US firm (established in 1924 by a former employee of Ernst & Ernst) and Thornton Baker, with 50 international member firms was created and named Grant Thornton International. In 1986 the UK and US member firms renamed themselves to Grant Thornton. A precursor to the Grant Thornton international network, Alexander Grant Tansley Witt, was created in 1969, when Alexander Grant formed alliances with firms from Australia, Canada and the UK. The UK member firm in the network was not related to Thornton Baker.

76. In 2007, GT (at that point either the fifth or sixth largest firm in the UK by revenue) merged with the UK firm of RSM Robson Rhodes (the 12th largest UK firm) which had been struggling financially. The merger led to the RSM network having to identify a replacement UK member firm (Bentley Jennison).

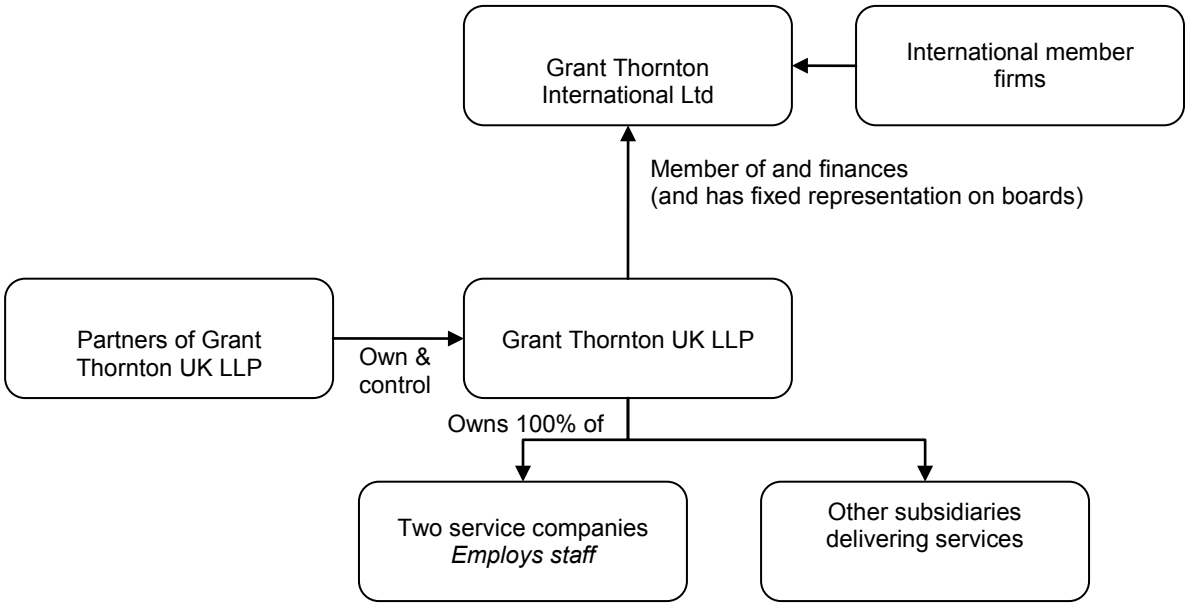
Legal and operational structure

77. GT is the UK member firm of the Grant Thornton network and is incorporated as a limited liability partnership.

[34] What's in a name, ICAEW.

FIGURE 5

Ownership and structure of Grant Thornton UK



Source: Analysis of GT Transparency Report.

78. GT reports internally through three managed divisions, which are a combination of geographic locations and service lines:

(a) Regions—36 per cent of revenue;

(b) London—28 per cent of revenue; and

(c) Advisory (National)—36 per cent of revenue.[35]

79. The Regions and London business units are further managed by service line of audit, tax and advisory. Advisory work is managed through three subunits; Forensic, Reorganisation and Recovery, and Corporate Finance.

80. The firm's governance structures are:

(a) The Partnership Oversight Board (POB) that oversees the National Leadership Board including the setting of the firm's statement of principles, determining profit-sharing arrangements and the nomination of a candidate for the position of

[35] Based on analysis of six-month management accounts to 31 December 2011.

CEO (which is subject to ratification by the firm's partnership). The POB is composed of nine elected partners, three independent non-executive members, with the CEO and two other members of the National Leadership Board acting as non-voting ex officio members. The Chair of the POB is selected by the members of the POB.

(b) The National Leadership Board is appointed by the CEO to act as the firm's senior management team, developing and executing the firm's strategy and has responsibility for regulatory compliance and compliance with the firm's statement of principles.

Relationship with network

81. GT is a member of GT International Ltd, a company limited by guarantee. As at 30 September 2011, there were 96 member firms with combined revenue of £2.3 billion and 30,000 personnel. GT's net revenue in 2011 was £351 million (14.1 per cent of the combined network figure) and employed 3,500 staff and partners (12.5 per cent of the combined network figure). GT is the second largest firm in the network, after the US firm.

82. The two principal governance structures of the network are:

(a) the Board of Governors that appoints the Global CEO and has responsibility for approving strategy and policies determined by the CEO. Members are 'selected from member firms worldwide';[36] and

(b) the Global Leadership Team, appointed by the Global CEO, with responsibility for execution of the network's strategy.

UK firm revenues

83. GT's UK revenues in 2011 were generated from the following service lines:

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[36] Grant Thornton Transparency Report 2011.

(a) Assurance (32 per cent);

(b) Tax (24 per cent);

(c) Corporate Finance (9 per cent);

(d) Forensic (5 per cent);

(e) Recovery and reorganization (26 per cent); and

(f) Other (4 per cent).

84. In the period 2004 to 2011, based on data submitted by GT, statutory audit accounted for between 31 and 35 per cent of the firm's revenue. In its 2011 Transparency Report, GT stated that 27 per cent of revenue was from statutory audit and 10 per cent was from non-audit services to audit clients.

85. Table 4 summarizes the sources of statutory audit revenue for GT.

TABLE 4 **GT revenue from statutory audit**

									£000
		2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
Audit fees	FTSE 100	-	-	-	-	-	-	-	-
	FTSE 250	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
	Other	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
	Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: GT

KPMG

History

86. KPMG's oldest UK predecessor firm, William Peat & Co. was established in 1870, by William Barclay Peat. The firm merged with Marwick Mitchell & Co in 1911 and became known as Peat Marwick.[37] The practice then grew organically until the Second World War. After 1945, the firm's expansion in the UK was driven by a series

[37] The relationship between the two firms was actually suspended between 1919 and 1925 before being resumed.

of mergers with regional firms, which led to it developing a position as one of the eight largest firms by the 1980s.[38]

87. KPMG was formed in 1986 when Peat Marwick merged with KMG Thomson McLintock, the tenth largest firm in the UK (and UK member firm of the KMG network). Thomson McLintock was established in Glasgow in 1877, and had operated in the UK as a federation of UK partnerships after its London and Glasgow offices formed separate partnerships. This decentralized structure encouraged other regional firms to join, in the knowledge they would retain a degree of autonomy and the firm targeted several regional firms to merge with during the 1960s to ensure a broad coverage of the UK.[39]

88. KMG was a network that developed from the deliberate strategy of Thomson McLintock to create an international network in lieu of establishing its own network of practice offices overseas, which had been necessitated by its existing clients expanding overseas. In 1964, a coordinating (and not practising) firm of McLintock Main Lafrentz International was created, with a US firm, Main Lafrentz. The network grew and in 1979 was renamed KMG (Klynveld Main Goedler) and in 1985 Thomson McLintock adopted the prefix KMG.[40]

89. In 1996 KPMG started to use KPMG Audit Plc to undertake the audit of all of its listed clients, as a way of ring-fencing risk in what KPMG perceived to be an increasingly litigious environment.[41] In 2002 the business of the unlimited UK partnership was transferred to a limited liability partnership.

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[38] KPMG response to the issues statement, paragraphs 36 & 37.
[39] Habgood, op cit, p29.
[40] KPMG response to the issues statement, paragraph 38.
[41] KPMG response to the issues statement, paragraph 39.

90. In 2007, after the implementation of the EU Statutory Audit Directive, which allowed pan-European ownership of audit firms, KPMG Europe LLP (ELLP) was created by the UK and German member firms and has since grown to encompass a number of European and Gulf member firms. However, ELLP does not itself undertake any client services, with member firms providing audit and other services in the relevant country.[42]

Legal and operational structure

91. KPMG provides statutory audit in Great Britain, along with its wholly-owned subsidiary, KPMG Audit Plc. KPMG's activities in Northern Ireland are undertaken by the KPMG member firm in the Republic of Ireland. Both the Channel Islands and the Isle of Man are separate KPMG member firms. KPMG is a member of KPMG International Cooperative, which is a Swiss 'cooperative', changing status from a Verein in 2003. The governance of KPMG International Cooperative is discussed below.

92. KPMG is incorporated as a LLP. Most UK partners are also members of ELLP. ELLP holds sufficient voting rights to control KPMG . When ELLP was created, it was a merger between the UK and German member firms; whilst KPMG remains a separate legal entity, it is controlled by ELLP, which itself is a LLP.[43,44]

93. Since the creation of ELLP, other European (and Gulf) KPMG member firms have joined, so that ELLP now effectively controls the operations of firms present in 18 countries.[45]

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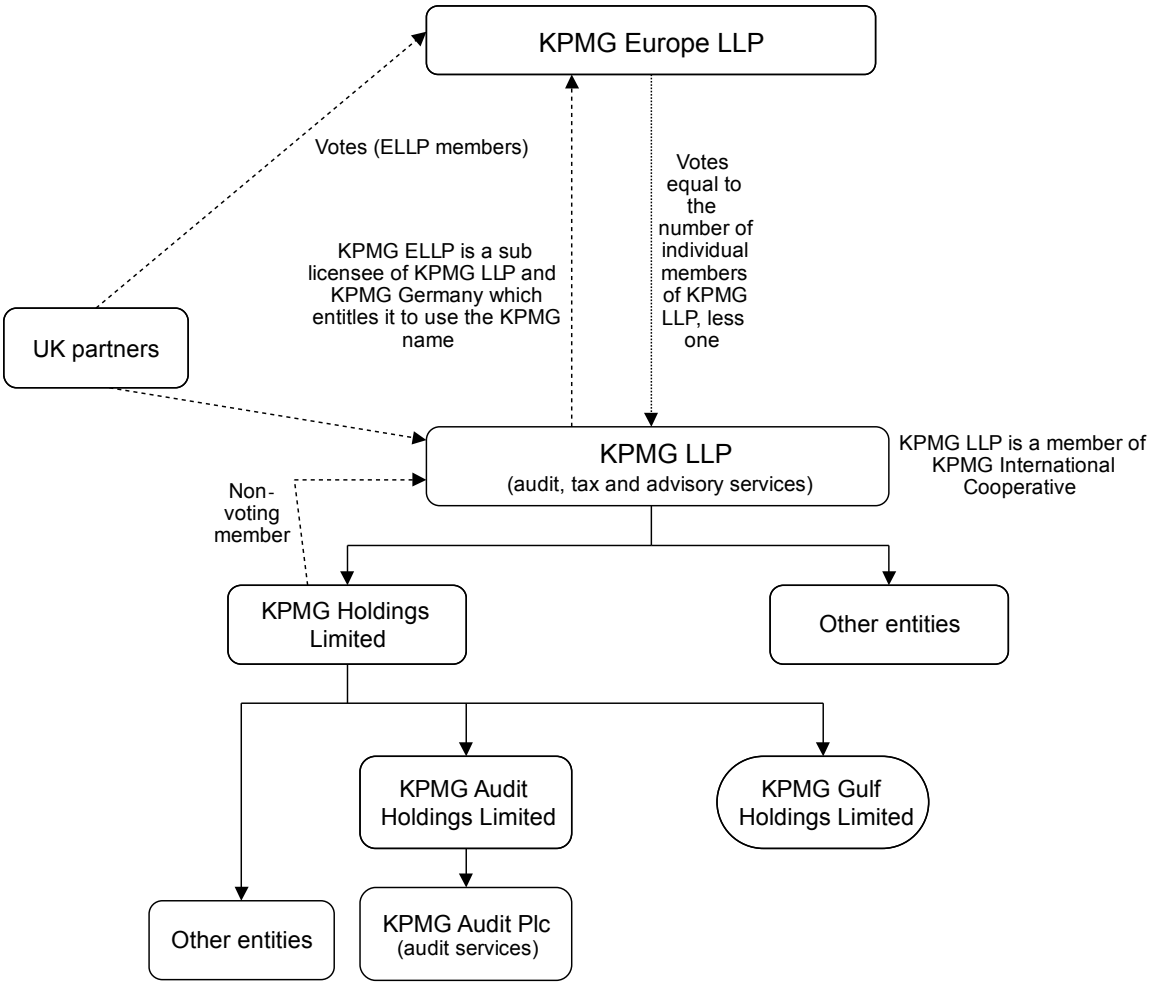
[42] KPMG response to the issues statement, paragraphs 43 & 44.
[43] The FRC/AIU describes the UK as being 'owned' by the ELLP; in fact it is controlled by ELLP.
[44] All partners have the same weighting in the ELLP. However, if a resolution that needs an exceptional or extraordinary majority fails, the resolution will be put to audit qualified partners (who must make up 10 per cent of all partners) and if they pass it, it is carried. No decisions in the ELLP are reserved for certain member firms.
[45] KPMG UK 2011 Transparency Report.

94. KPMG Gulf Holdings Limited holds call options in a number of Gulf operations. KPMG in Saudi Arabia is (deemed to be) controlled, for the purposes of the relevant IFRS, whereas Kuwait and Jordan are subject to significant influence. KPMG Gulf Holdings Limited is an indirect subsidiary of KPMG..

95. KPMG is notable for the use of a separate subsidiary, KPMG Audit Plc, for the audit of its Public Interest Entity (PIE) clients, which includes nearly all listed company and financial services audits.

FIGURE 6

Ownership and structure of KPMG



Source: CC analysis of financial statements and 'off the shelf' material.

96. ELLP has control of KPMG . As noted, ELLP also controls or has interests in member firms operating in 18 countries, with the UK firm being the single largest division of

ELLP, accounting for approximately one-third of ELLP's staff and 40 per cent of its revenue. From 2011, a small percentage of profits generated by member firms within ELLP is pooled and distributed to those ELLP partners who have best exhibited a pan-European mindset within ELLP.[46,47] The net amounts actually transferred from one country to another are, however, minimal.

97. ELLP has a board which exercises power in all areas except a few relating to organization structure and composition, which must be voted on by the members. Its principal functions are to set strategy and policy and oversee the ELLP Executive Committee. The board is comprised of two joint Chairmen, ten executive partners, and 15 non-executive partners. All members of the board are ratified by the ELLP partnership.[48]

98. Six main bodies report to the board, the most significant of which is the Executive Committee. The Executive Committee is responsible for various matters, including the financial performance of ELLP, developing new business areas and recommending policy to the board.

99. Day-to-day management of KPMG UK and responsibility for compliance with UK regulatory requirements remains the responsibility of a UK executive, known as the 'UK Operating Team'. Although there is a UK 'board' its primary purpose is for the completion of governance duties such as recommending the approval of the accounts to the voting members.

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[46] KPMG Europe LLP, Annual Report 2011, Chief Operating Officers Review: 'This year we have also agreed, across ELLP firms, to the greater sharing of economic interests which allows the KPMG Europe LLP leadership to reward positive partner performance regardless of the geography (or geographies) that directly profits from that performance. This is a hugely positive step in our ELLP journey, as it removes potential geographical obstacles to getting the best expertise for our clients.'
[47] An individual partner's profit share will be largely driven by the financial performance of that partner's firm.
[48] Since the publication of the working paper 'The suppliers of statutory audit services to large companies', both KPMG Europe and KPMG UK have undertaken some changes to their governance and management structures which are not reflected here. For details of these changes see p.8-9 of KMPG LLP (UK) 2012 Transparency Report

100. KPMG has a separate subsidiary (KPMG UK Ltd) to provide staff and services to the partnership and those of its subsidiaries which provide services to clients. It is unusual in using a separate entity, KPMG Audit Plc, to undertake its public interest audits, and it is the name of this subsidiary that appears on the audit reports for most PIE clients. After management charges to the Plc for overheads incurred by KPMG and charges for staff from KPMG UK Ltd, the Plc does not normally generate a significant profit, with substantially all profits arising in the LLP.

Relationship with network

101. In aggregate member firms of the KPMG network of independent firms operate in 152 countries. The structure of the KPMG network 'is designed to support consistency of service quality and adherence to agreed values'. KPMG International Cooperative 'establishes, and facilitates the implementation and maintenance of uniform policies and standards of work … and protects and enhances the use of the KPMG name and brand'.[49] KPMG International Cooperative has 55 member firms and approximately 283 practising sublicensee firms (together commonly referred to as 'member firms').

102. Member firms of KPMG International are required to have 'the capability to provide certain types of core services and to refer work to other member firms where appropriate'. The contributions to KPMG International by member firms are determined by [✂]. KPMG contributes [✂] per cent of revenues as a levy to KPMG International Cooperative which in 2011 amounted to £[✂].

103. The principal governance structures of KPMG International Cooperative are:

(a) The Global Council focuses on high-level governance and acts as a forum for communication between member firms. The Council elects the KPMG

[49] KPMG LLP Transparency Report 2011.

International Chairman and approves the appointment of members of the Global Board.

(b) The Global Board has responsibility for approving strategy and policies, protecting the KPMG brand (including admission of member firms), and management of KPMG International. Membership consists of the Chairman and Deputy Chairman and the Chairman of the three geographic regions (Americas, Asia-Pacific and, Europe, the Middle East and Africa) and a number of senior partners from member firms.

(c) The Global Executive Team is led by the Chairman and is supported by the Global Practice Heads, and manages KPMG International. It has responsibility for execution of strategy approved by the Global Board.

104. Each of the three geographic regions also has a Regional Board with its own Chairman and chief operating or executive officer. The Regional Boards assist with implementing policy in their region.

UK firm revenues

105. KPMG's UK revenues are generated through a number of service lines:

(a) Audit (27 per cent);

(b) Tax (25 per cent);

(c) Transactions and restructuring (21 per cent);

(d) Risk and compliance (12 per cent); and

(e) Performance and technology (15 per cent).[50]

106. Table 5 summarizes the source of KPMG's statutory audit revenue.

[50] Analysis of September 2011 Management Accounts.

TABLE 5 **KPMG statutory audit revenue**

£'000

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
FTSE 100	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
FTSE 250	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: KPMG

Mazars

History

107. Mazars was established in Normandy, France in 1940 and remained a largely local firm until the 1980s. It expanded to the UK in 1998 when the British firm of Neville Russell (established 1901) joined its network. Mazars expanded through some local mergers and the creation of new offices in overseas territories. In 2007 Mazars joined the Praxity alliance, which at that point had member firms in 75 countries.

108. In 2007 the UK firm merged with MRI Moores Rowland, a British firm.[51]

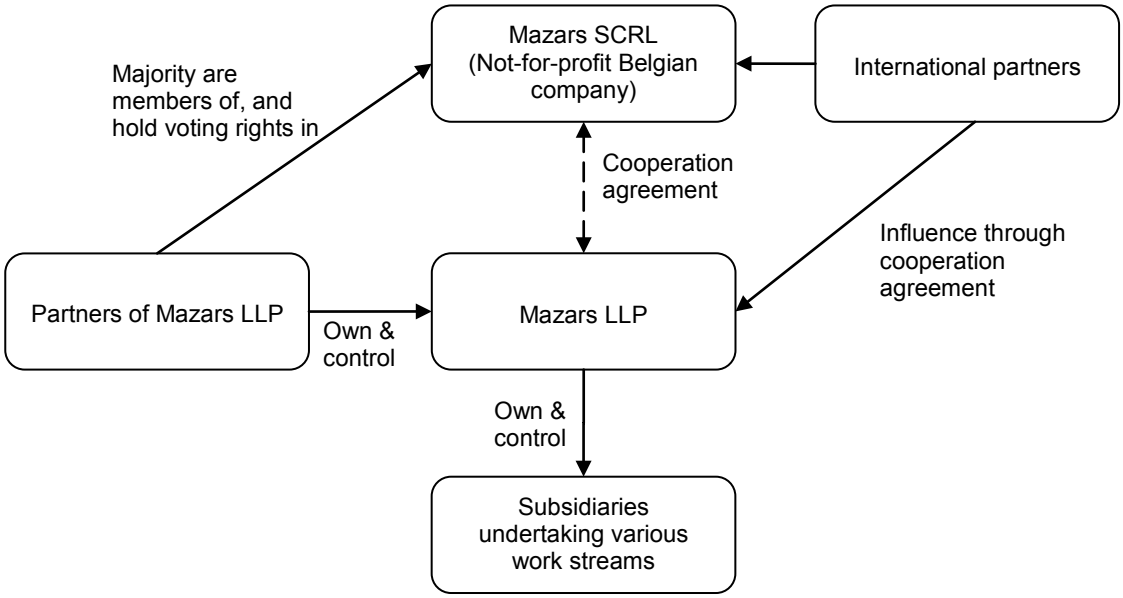
Legal and operational structure

109. Figure 7 shows the legal structure of Mazars, and its ownership by its partners. The relationship between the firm and Mazars globally is discussed below.

[51] Moores Rowland was an association of regional partnerships that had roots in a firm established in 1866. In 1999 ten of its offices joined BDO Stoy Hayward with a number of other offices joining other firms.

FIGURE 7

Ownership and structure of Mazars



Source: CC analysis of MFQ and corporate documents.

110. Mazars is a LLP, owned by its partners. Approximately two-thirds of its partners are also members of Mazars SCRL, a Belgian not-for-profit company (these partners are referred to as International Partners in this appendix). The voting power of International Partners is weighted for matters relating to Mazars, so that each partner has twice the number of votes of a non-International Partner.

111. Non-International Partners receive a fixed share of Mazars' profits plus an additional performance related amount. Partners who are members of Mazars SCRL are allocated profit sharing 'points' which are reviewed every three years. Capital contributions of International Partners range from [✂] depending on profit points, whilst non-International Partners must contribute either £[✂] or £[✂] depending on their allocated profit share.

112. Mazars structures its business around two Country Business Units (CBUs): PIEs (44 per cent of firm net revenue), and Owner Manager Businesses (OMB) (56 per cent of firm net revenue).[52]

113. The firm's offices are managed as either PIE (London, Luton and Jersey) or OMB (all other offices). The CBUs are then managed by Operational Business Units (OBU), which for the OMB CBU is done on a geographic basis.

114. The OBUs for the PIE CBU are based on service lines:

(a) Audit—47 per cent of PIE revenue;

(b) Tax—21 per cent of PIE revenue;

(c) Actuarial—3 per cent of PIE revenue;

(d) Advisory—20 per cent of PIE revenue;

(e) Internal Control—9 per cent of PIE revenue; and

(f) Outsourcing.[53]

115. Audit and Assurance are overseen by the Audit and Assurance Group, which reports to the National Executive. The CBUs are supported by the Country Support Unit. Not all PIE clients are audited by the PIE CBU and vice versa, however, the PIE CBU has ultimate responsibility for all PIE clients.

116. The principal governance arrangements of the firm are as follows:

(a) The National Senior Partner is elected by the UK partners. The Senior Partner nominates an executive team, which is then ratified by the UK partnership.

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[52] CC analysis of Mazars August 2011 Management Accounts.
[53] Analysis of Mazars August 2011 Management Accounts. Outsourcing is not reported as a separate line. Service lines are not separately analysed for the whole firm.

(b) The Executive and the Senior Partner are responsible for setting and delivering the firm's strategy. The Executive is also responsible for setting a management structure that is consistent with Mazars globally.

(c) The Governance Council is elected by the partners and oversees the work of the executive on behalf of the partnership as a whole. The Council is also responsible for the arrangements of the partnership including membership and remuneration.

Relationship with network

117. Mazars differs from the typical network model, describing itself as a 'partnership of partners' and as an 'integrated partnership'. As noted above, two-thirds of partners are International Partners, owning a share in Mazars SCRL and control approximately [✂] per cent of voting rights in the UK firm. It is the intention of the firm that this will increase to [✂] per cent in the future, to ensure consistency with firms internationally.

118. The international governance structures of Mazars SCRL are:

(a) The Group Executive Board is led by the global President (Chair) and Chief Executive of Mazars and is composed of members nominated by the President and ratified by the members of SCRL. The Executive Board is responsible for key strategic decisions. The Chair is elected by the members every three years.

(b) The Group Governance Council is elected by the members of Mazars SCRL to administer the admission of new partners and oversee the work of the Executive Board and global business units (individual territories). It meets every four months.

(c) Global Business Units manage 'country business units' from an international perspective, with management of local issues undertaken by the CBU.

(d) The Global Strategic Committee has responsibility for 'proposing and supporting the Group's strategic developments around the world'.[54]

(e) The Global Executive Committee includes members of the Group Executive Board and representatives of the Global Business Units and Support Units and is responsible for global coordination and day-to-day operational management of Mazars globally, and meets monthly.

119. The UK firm's structure was introduced in 2009 as part of an international standardization of management structures in member firms. Internationally, Mazars monitors its performance through four business units, being PIE, OMB, Tax and Law. In the UK, Tax is included within PIE or OMB and there is no legal practice.

120. There are 'integrated' firms in 69 countries and non-integrated in 15 countries. Non-'Integrated' firms are joint ventures and correspondent firms which include members of the Praxity alliance.

UK Firm Revenues

121. In the period 2004 to 2011, between 34 and 39 per cent of Mazars' UK revenue was derived from statutory audit. The firm's income is generated by the following service lines:

(a) Audit and assurance (41 per cent);

(b) Accounting and financial (7 per cent); and

(c) Specialized services[55] (52 per cent).[56]

122. Table 6 summarizes the source of statutory audit revenue for Mazars.

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[54] www.mazars.com/Home/About-us/Key-facts-organisation/Management-of-the-Group/Global-Strategic-Committee.
[55] Includes Transaction Services, Risk Management and Internal Control, Organisation and IT Services and Actuarial Services.
[56] Analysis of Mazars LLP 2011 Transparency report.

TABLE 6 **Mazars UK revenue from statutory audit**

£000

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
FTSE 100	-	-	-	-	-	-	-	-
FTSE 250	[✂]	[✂]	-	-	-	-	-	-
Other	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: Mazars

PKF

History

123. PKF, UK, formerly known as Pannell Kerr Forster, was established in 1869 by WH Pannell. The firm merged with two other firms in 1945 and merged again in 1963 and 1978.[57] In 1969, the firm created a network with firms in Australia, Canada and the USA. The four founding firms adopted the name, Pannell Kerr Forster in 1980 (from the British and US member firm Harris, Kerr and Forster). The network's name was shortened to PKF in 2000.

124. Not all member firms adopt the PKF brand name.

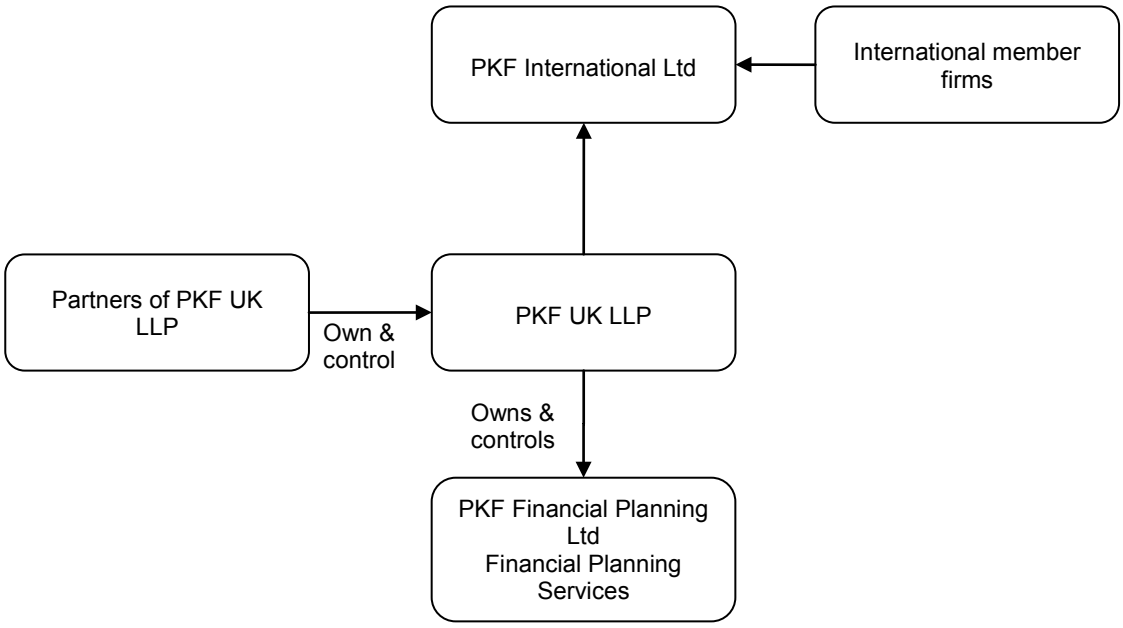
Legal and operational structure

125. PKF is the UK member firm of the PKF network and is incorporated as a limited liability partnership. PKF is a member of PKF International Ltd.

[57] The companies PKF merged with were Crewdson, Youwett & Howard, and Lewis Hardy & Co in 1945; Fitzpatrick, Graham & Co in 1963; and Keens, Shay, Keens & Co in 1978. It also subsequently merged with Rowley, Pemberton, Roberts & Co in 1980 and Ball Baker Leake in 1985.

FIGURE 8

PKF organizational structure



Source: PKF Transparency Report.

126. The governance framework for PKF is as follows:

(a) The board is chaired by the Senior Partner, who is elected every three years and three other partners who are elected, and the Managing partner and two other members of the management team.

(b) The Managing Partner is responsible for the firm's strategic direction and management including financial performance and the quality of professional services. The Managing Partner is appointed by the Nomination Committee, established by the board.

127. Whilst the firm offers a number of service lines as outlined in paragraph 131, the firm is managed for certain services by Regional Managing Partners on a geographic basis and by heads of certain specialized services on a national silo basis.

Relationship with network

128. Membership of the PKF network is through membership of PKF International Ltd, a company limited by guarantee.

129. The network has member firms and both exclusive and non-exclusive correspondent firms.

130. Governance of the network is overseen by the International Board. The Board has a created a number of committees including the International Professional Standards Committee which sets the minimum professional standards to be met by member firms and promotes audit materials and capabilities. A number of other committees are responsible for other service lines.

UK firm revenues

131. PKF generates its revenues through a number of service lines:

(a) audit and assurance (42 per cent);

(b) taxation (21 per cent);

(c) corporate finance and forensic (9 per cent);

(d) corporate recovery and insolvency (11 per cent); and

(e) management consulting (18 per cent).[58]

132. Statutory audit comprises the majority of the audit and assurance practice, and is the source of 32 per cent of the firm's revenue.

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[58] PKF UK Transparency Report 2011.

TABLE 7 **PKF statutory audit revenue**

£'000

	2004	2005	2006	2007	2008	2009	2010	2011
FTSE 100	-	-	-	-	-	-	-	-
FTSE 250	-	-	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other	-	-	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	-	-	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: PKF

Other

133. On 7 November 2012, BDO and PKF announced that they intend to merge.

PwC

History

134. PwC was formed in 1998 on the merger of the two UK firms of Price Waterhouse and Coopers & Lybrand, which formed part of the merger of their respective networks. The merger of the two networks was approved by the European Commission.[59]

135. Both Price Waterhouse and Coopers & Lybrand's oldest founding firms were established in the 19th century. Coopers & Lybrand's predecessor UK firm, Cooper Brothers & Co had been established in 1854. In 1946, in part due to the need to replace overseas offices which had been forced to close during the Second World War, Coopers decided to create an international network, allowing it to be represented globally by indigenous firms in addition to the overseas offices it had established itself. This led to a period of increased international activity.[60,61]

136. Coopers & Lybrand was formed in 1957, through an alliance of three firms. One of each of the three firms had been founded in the UK, USA or Canada respectively. All three firms had established overseas offices and the alliance was seen to be

[59] Case No IV/M.1016—Price Waterhouse/Coopers & Lybrand.
[60] For example, in 1948 a relationship with a large US firm, Scovell, Washington & Co, was established.
[61] Overview of firm history based on Boys, P, op cit.

mutually beneficial, particularly to the US firm due to the increase in the level of investment by US firms in the UK. The name Coopers & Lybrand was used in international practice whilst the founding firms retained their own names in their domestic territories. It was not until 1973 that all member firms adopted the Coopers & Lybrand name.

137. Price Waterhouse was established in the UK in 1849. Unlike other networks, the Price Waterhouse network developed through organic international expansion driven by the UK firm, establishing new autonomous partnerships in each territory it wished to expand into, though, did also enter into agency arrangements with local firms to carry out work under its name and shared overseas offices with other British firms.

138. The merger of Price Waterhouse and Coopers & Lybrand in the UK created the largest firm in the audit market, with 50 per cent of the FTSE 100 and 37 per cent of the FTSE 250 being clients of the combined firm in 1998. Between 1998 and 2010 the firm lost market share with respect to the number of clients, ending the period with 38 FTSE100 audit clients and 26 per cent of the FTSE 250.

Legal and operational structure

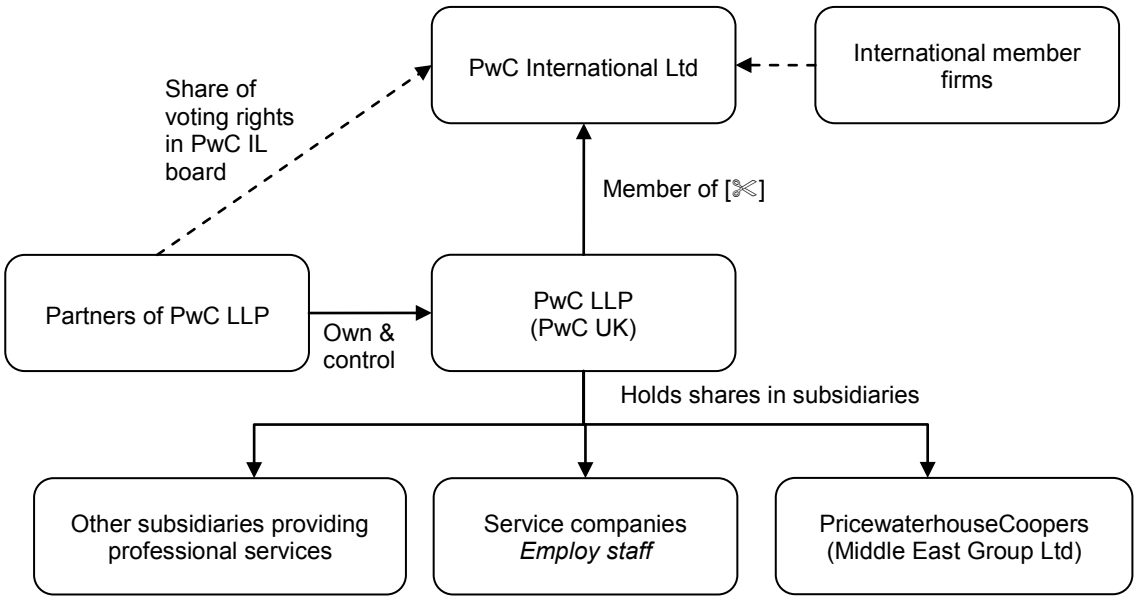
139. PwC is incorporated as a LLP and is a member of PwC International Ltd, a company limited by guarantee and which is the network body. As a member of PwC International, the PwC partners, who own the UK firm, have the ability to exercise voting rights in the network body. Details of the arrangements with the network are discussed below. The legal structure of PwC is shown below in Figure 9.

140. As with the other firms, PwC has a number of subsidiaries, which exist for a variety of purposes, such as the employment of staff.

141. In addition to PwC, there is also a UK law firm, PwC Legal, which is part of the PwC network and is a separate, independently owned legal entity. Due to the nature of its relationship to PwC, PwC Legal is consolidated into PwC's financial statements under IAS 27, but there is no sharing of profits between the two entities and their respective members.[62]

FIGURE 9

PwC ownership and legal structure



Source: CC analysis of financial statements and 'off the shelf' material.
Note: Dashed line indicates membership but not ownership.

142. PwC is managed through three service lines and a number of market segments, though it is the service lines that form the primary division of the firm. The service lines are:

(a) Assurance—[✂] per cent of revenue; 6,600 partners and staff;

(b) Advisory—[✂] per cent of revenue; 4,100 partners and staff; and

[62] PwC LLP Annual Report, Note 23 to the financial statements.

(c) Tax—[✂] per cent of revenue; 3,000 partners and staff.[63]

143. The assurance practice which provides (among other things) statutory audit services, is divided into:

(a) Core Assurance;

(b) Risk Assurance Services (RAS);

(c) Actuarial and Insurance Management Services (AIMS); and

(d) Capital markets, Accounting Advisory and Structuring (CMAS).

144. Approximately [✂] of RAS's workload relates to statutory audit. Core Assurance and RAS work for large firms are managed through ten units, six of which are regional, with an additional four in London, focusing on:

(a) Banking and Capital Markets;

(b) Insurance and Investment Management;

(c) London Top Tier; and

(d) London Mid Tier.

145. In addition to the service lines, there are overarching management structures for oversight of the business by markets and regions.

146. There are, in addition, three main bodies that, respectively, govern, supervise and exercise oversight of the firm as a whole:

(a) Executive Board—chaired by the Senior Partner, including the Lines of Service leaders and is responsible for the strategy, direction and management of the firm.

(b) Supervisory Board—independent of the Executive Board, and elected by the partners to oversee and protect the interests of the partners.

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[63] Figures do not sum to 100 due to rounding and a small 'year end adjustment' not allocated to a specific line of service.

(c) Public Interest Body—discharges the requirements of the Audit Firm Governance Code and includes non-executive members.

Relationship with network

147. The PwC network covers over 150 countries and employs some 169,000 staff as of 2011. There is no profit sharing across the network. Governance of the network is through four bodies:

(a) The Network Leadership Team (NLT) sets strategy and standards that all member firms have to apply. The NLT is formed of the Senior Partners from the US, UK and China member firms and the Chairman of the PwC network and a fifth member appointed by the Global Board.

(b) The Strategy Council, which is made up of leaders of the largest PwC member firms, is responsible for agreeing any proposed change in strategy and direction for the network.

(c) The Network Executive Team is appointed by the NLT, which it reports in to, has responsibility for consistency across key service lines and functional areas such as Risk and Quality, Human Capital, Operations, Communications and branding.

(d) The Global Board provides oversight of the NLT and approves network standards. Members are elected by partners from all member firms every four years.

148. All member firms must agree to abide by network standards. Member firms are responsible for implementing appropriate quality control arrangements and these are subject to periodic review by the network.

149. The UK firm has a permanent seat on the NLT and therefore is certain to have its views represented when the network determines its strategy. UK partners elect the firm's Senior Partner and also have opportunity to vote to elect members of the

Global Board; currently two of the 18 members are UK partners and also have opportunity to vote to elect members of the Global Board; currently two of the 18 members are PwC UK firm partners.

UK firm revenues

150. PwC generates its revenues through three service lines:

(a) Assurance ([✂] per cent);

(b) Advisory ([✂] per cent); and

(c) Tax ([✂] per cent).

151. Table 8 provides a summary of the source of PwC's statutory audit revenue.

TABLE 8 **PwC statutory audit revenue**

£000

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
FTSE 100	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
FTSE 250	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: PwC

Development of the statutory audit

Introduction and summary

1. This appendix considers the development of the statutory audit of companies' financial statements from their origins in Victorian legislation to the present day.

2. The development of the statutory audit was linked both to the development of company law and to the establishment and subsequent growth of audit firms.

3. The common law principles established by Victorian case law have remained unchanged in modern times. Many of the statutory arrangements were also first set out in Victorian legislation. However, after 1970 auditing and accounting standards have played an increasingly important role in auditing, and as from 2 July 2012 the Government replaced the exisiting delegation of functions of the Secretary of State under Part 42 of the Act concerning auditors with a new delegation in favour of the reorganized FRC.[1]

4. Landmark dates include:

1844	Mandatory financial auditing provisions first appeared.
1856	The policy decision was taken to make auditing arrangements optional.
1895/96	The *London and General Bank* and *Kingston Cotton Mill Company* cases were decided.
1900	Auditing provisions were once more made mandatory.
1947	'True and fair view' requirement introduced by Companies Act 1947.
1948	Appropriately qualified accountants given a monopoly of auditing.
1970	Accounting Standards Steering Committee created.

[1] The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012 (SI 2012 No 1741).

1976 Auditing Practices Committee (APC) of the Committee of Consultative Accountancy Bodies (CCAB) established to produce professional standards and working guidelines for auditors.

1978 4th Council Directive on annual accounts (adopts 'true and fair view').

1980 First auditing standards and guidelines published.

1981 Companies Act 1981 gives effect to 4th Directive.

1983 7th Council Directive on consolidated accounts.

1984 8th Council Directive on approval of persons responsible for statutory audits.

1989 Companies Act 1989 gives statutory recognition to accounting standards; auditors required to disclose fees paid for non-audit work; audit firms could become limited liability companies; audit firms required to be member of a recognized Supervisory Body before auditing UK registered company.

1990 *Caparo Industries plc v Dickman* case decided by House of Lords (duty of care of statutory auditors).

1990 The FRC incorporated and first auditing standards and guidelines issued.

1991 Auditing Practices Board established by CCAB to replace APC.

1991 UK audit regulations.

1992 Cadbury Committee report on Financial Aspects of Corporate Governance.

1998 Combined Code on Corporate Governance published.

2000 Audit firms could become limited liability partnerships.

2002 EC Regulation No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

2003 Smith: *Audit committees: Combined Code guidance*, published by FRC.

2004 APB publishes five ethical standards for auditors.

2004 APB issues International Standards on Auditing (ISA) for UK and Ireland and the International Standard on Quality Control (ISQC) (UK and Ireland) 1.

2006 Directive 2006/43/EC on statutory audits.

2006 The current consolidating Companies Act was passed, giving effect to Directive 2006/43/EC; making it a criminal offence knowingly to issue a misleading audit report, but enabling auditors to agree a cap on liability with the company.

2008 The banking crisis.

2008 Chapter 7.1 (Audit Committees) added to Disclosure Rules & Transparency Rules.

2009 APB issues 33 new ISAs (UK & Ireland) and replaces ISQC (UK and Ireland) 1.

2010 UK Corporate Governance Code published.

2010 FRC and the Institute of Chartered Accountants in England and Wales (ICAEW) issue Audit Firm Governance Code (applies to firms which audit more than 20 companies listed on the Main Market of the London Stock Exchange).

2010 FRC issues Guidance on ACs.

2011 European Commission proposal for a regulation to increase the quality of audits of public-interest entities (PIE), and for a directive to enhance the single market for statutory audits.

2012 FRC assumes responsibility for accounting and ethical standards; APB is replaced by the Audit & Assurance Council; and AIU becomes the Audit Quality Review Team (AQRT).

1844 to 1900

5. Modern statutory audit provisions derive from Victorian companies legislation. Prior to 1844, the creation of a corporate body required a Royal Charter[2] or an Act of Parliament. However, this was unsuited to provide the support and funding needed for the Industrial Revolution, as support for obtaining a Royal Charter often, in practice, involved payments being made to the Crown,[3] and private Acts of Parliament were expensive and required Parliamentary time to be available.[4]

6. Unincorporated joint stock companies with transferrable shares, but based on partnership, were an alternative way of raising finance through shares. The Bubble Act 1720 had been passed to prohibit such unincorporated joint stock companies. However, it was unclear from the drafting whether this was a total prohibition, or a prohibition only on such companies whose objects were not in the public interest, and

[2] The East India Company is a well-known example of such a body. Originally, Royal Charters were in the exclusive gift of the Crown, but the Statute of Monopolies 1623 (c.3) prohibited such Charters unless allowed or confirmed by Act of Parliament.
[3] For example, by the Bubble Act 1720 (6 Geo 4 c.91), Lord Onslow was granted a Charter for The Royal Exchange to write marine insurance, but only after he had offered £300,000 towards the King's Civil List debts.
[4] This was especially so for railway and waterway development. In 1846, Parliament passed 272 Railway Acts.

unclear whether such joint stock companies were contrary to common law.[5] Following repeal of the Bubble Act in 1825,[6] the number of such joint stock companies increased, but this led to claims of fraud and financial irregularities.

7. A select committee (chaired by the President of the Board of Trade, William Gladstone) was appointed to inquire into the law relating to bubble companies[7] in view of the circumstances of fraud and mismanagement in the conduct of such companies, and the report of this committee in 1844[8] led to the enactment of the Joint Stock Companies Act 1844. This 1844 Act created the office of Registrar of Joint Stock Companies, and enabled companies to be incorporated by registration of a deed of incorporation.

8. The main concern of the select committee was whether incorporation of companies by registration would reduce fraud and mismanagement, or encourage it. The committee considered that the problem of mismanaged companies could be addressed by:

> the periodical balancing, audit and publication of accounts and by making the directors and officers more immediately responsible to the shareholders. … Periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern and … parties to mismanagement may be made more amenable for acts of fraud and illegality.[9]

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[5] In *Kinder v Taylor (1825) 3 LJ Ch 68*, Lord Eldon had held that it was contrary to common law in England 'to act as a corporation, not being a corporation' (the position appears to have been different in Scotland) but the provisions of section 18 of the Bubble Act were unclear and unincorporated joint-stock companies with transferable shares, based on partnership, were common.
[6] By the Bubble Companies etc Act 1825 (6 Geo 4 c.91).
[7] A 'bubble' company is one whose share price has been increased by speculators to unreasonable levels, unsupported by the company's fundamentals, so that when the bubble bursts the shares become worthless and investors make great losses. Overstated valuations and even fraud may be used by management to encourage continued investment in the company.
[8] Report of the Select Committee on Joint Stock Companies (P.P. 1844, VII).
[9] Report of the Select Committee on Joint Stock Companies (1P.P. 1844), p v.

9. Accordingly, the 1844 Act introduced the following requirements as regards audits. These are broadly similar to the duties that apply today:

- One or more auditors must be appointed in the formation deed (section VII).
- The directors must cause the books of the company to be balanced, and a full and fair balance sheet to be made up (section XXXV).
- Company to appoint auditors annually at a general meeting (section XXXVIII).
- At least one auditor must be appointed by the shareholders (section XXXVIII).
- Board of Trade to appoint auditor if none appointed by the shareholders (section XXXVIII).
- Directors to deliver the accounts and balance sheet to the auditors at least 28 days before the relevant ordinary meeting for examination (section XXXIX).
- Auditors to report within 14 days to the directors (not the shareholders) and either confirm the accounts or, if they do not see proper to confirm such accounts, report specially thereon (section XLI).
- Directors to send a printed copy of the balance sheet and auditors' report to every shareholder ten days before the ordinary meeting, and to read the report at the meeting together with the report of the directors (section XLII).
- Auditors authorized to inspect the books at any reasonable time and to receive assistance from the officers and staff of the company (section XL).
- A copy of the balance sheet and of the auditors' report to be filed at the registry (section XLIII).

10. The 1844 Act did not work well in practice[10] and the audit provisions were ineffective. For example, shareholders were provided with information as to the accounts, but the quality of that information was uncertain, as the requirement for the shareholders to

[10] Largely because its procedure of provisional registration, followed by complete registration, was exploited by some companies, which failed to complete the formalities but held themselves out as being backed by statute and full registration.

appoint at least one of the auditors did not ensure either the independence or the competence of the auditors.

11. Nevertheless, the policy aim appears for the 1844 Act to be a means of safeguarding against mismanagement and fraud[11] and compulsory statutory financial audit as one of the means of achieving that aim.

12. An important development in company law was the passing in 1855 of the Limited Liability Act[12] giving protection from liability to shareholders, and further distinguishing companies from partnerships.

13. The 1844 Act was replaced by the Joint Stock Companies Act 1856, which was less prescriptive, and placed the minimum cost and restriction on business. In introducing the Bill, Robert Lowe (Vice President of the Board of Trade) stated that 'the principle we should adopt is this—not to throw the slightest obstacle in the way of limited companies being formed'.[13]

14. The 1856 Act introduced the now familiar arrangements for incorporation of submitting a signed Memorandum of Association and Articles of Association to the Registrar for registration. Model articles of association were in a schedule to the 1856 Act, but as Robert Lowe stated:

> When those articles appear to the persons who have signed the articles of association to be applicable to the company, they may be adopted bodily without any expense; but if it should turn out that those rules are

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[11] Mr Gladstone said when introducing the Bill that:

> There were two classes of evils connected with Joint-Stock Companies that required a remedy. The first was the formation of fraudulent companies, into which innocent and inexperienced persons were induced to enter on account of the respectability of the names connected with them, to their own great, and, in many instances, ruinous loss. The other class was that of the formation of companies which, although not dishonest, were badly constructed and unwisely conceived.

HC Deb 2 April 1844 Vol 73 col 1755.

[12] The Limited Liability Act 1855 (18 & 19 Vict c 133).

[13] HC Deb 01 February 1856 vol 140 col 131.

> not applicable to a particular company, the company will have the power of filing a document with their memorandum of association, either specifying the whole code which they have agreed upon, or enumerating such of the rules as they do not adopt, and giving those which they substitute for them. There is no compulsion, therefore, in the matter. We leave companies to form their constitutions as they please; but if the constitution provided by the Act be suitable to the promoters, they will have the advantage of being able to adopt it without expense.[14]

15. The audit arrangements were, therefore, moved to a Schedule and formed part of 'Table A – regulations for management of a company limited by shares'.

16. The model articles as regards audit were similar to those which were in the 1844 Act. In some respects, however, the model provisions were improvements. For example, the auditors must state to the shareholders 'whether, in their opinion, the balance sheet is a full and fair balance sheet' (the 1844 Act required directors to cause a full and fair balance sheet to be drawn up, and the auditors confirmed the accounts). In the 1856 Act, the auditor 'may, at the expense of the company, employ accountants or other persons to assist him in investigating such accounts, and he may in relation to such accounts examine the directors or any other officer of the company'. However, companies were not required to use the model articles, and so the major weakness was that these arrangements did not apply to many, perhaps most, companies.

17. The Audit provisions of the model articles in the 1856 Act are as follows:

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[14] See footnote to paragraph 13.

74 The accounts of the company shall be examined and the correctness of the balance sheet ascertained by one or more auditor or auditors to be elected by the company in general meeting.

75 If not more than one auditor is appointed, all the provisions herein contained relating to auditors shall apply to him.

76 The auditors need not be shareholders in the company: no person is eligible as an auditor who is interested otherwise than as a shareholder in any transaction of the company; and no director or other officer of the company is eligible during his continuance in office.

77 The election of auditors shall be made by the company at their ordinary meeting, or, if there are more than one, at their first ordinary meeting in each year.

78 The remuneration of the auditors shall be fixed by the company at the time of their election.

79 Any auditor shall be re-eligible on his quitting office.

80 If any casual vacancy occurs in the office of auditor, the directors shall forthwith call an extraordinary general meeting for the purpose of supplying the same.

81 If no election of auditors is made in manner aforesaid, the Board of Trade may, on the application of one fifth in number of the shareholders of the company, appoint an auditor for the current year, and fix the remuneration to be paid to him by the company for his services.

82 Every auditor shall be supplied with a copy of the balance sheet, and it shall be his duty to examine the same, with the accounts and vouchers relating thereto.

83 Every auditor shall have a list delivered to him of all books kept by the company, and he shall at all times have access to the books and accounts of the company: He may, at the expense of the company,

employ accountants or other persons to assist him in investigating such accounts, and he may in relation to such accounts examine the directors or any other officer of the company.

84 The auditors shall make a report to the shareholders upon the balance sheet and accounts, and in every such report they shall state whether, in their opinion, the balance sheet is a full and fair balance sheet, containing the particulars required by these regulations, and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, and in case they have called for explanations or information from the directors, whether such explanations or information have been given by the directors, and whether they have been satisfactory; and such report shall be read, together with the report of the directors, at the ordinary meeting.

18. When the Companies Act 1862 consolidated company legislation,[15] the Table A model provisions as to audit remained broadly the same as in the 1856 Act. Members of the company (but not directors or other officers of the company) could be auditors, and it was sufficient for one auditor to be appointed.

19. The model articles provided that: 'Once at the least in every year the accounts of the company shall be examined, and the correctness of the balance sheet ascertained, by one or more auditor or auditors';[16] and 'Every auditor shall be supplied with a copy of the balance sheet, and it shall be his duty to examine the same, with the accounts and vouchers relating thereto'.[17]

20. The 'full and fair' test continued to apply also:

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[15] The1862 Act was that under which the landmark company law case of *Salomon v A Salomon & Co Ltd [1897] AC 22* on the doctrine of corporate personality was decided.
[16] Table A, paragraph 83.
[17] Table A, paragraph 92.

> The auditors shall make a report to the members upon the balance sheet and accounts, and in every such report they shall state whether, in their opinion, the balance sheet is a full and fair balance sheet, containing the particulars required by these regulations, and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, and in case they have called for explanations or information from the directors, whether such explanations or information have been given by the directors, and whether they have been satisfactory; and such report shall be read, together with the report of the directors, at the ordinary meeting.[18]

21. In the case of a company limited by guarantee (ie not having a capital divided into shares) such as would be the case for a mutual insurance company, the model articles in Table B of the 1862 Act provided that 'The accounts of the company shall be audited by a committee of five members, to be called the audit committee'. This 'audit committee' carried out functions similar to those carried out by the auditors of a company limited by shares, and had the duty under the model articles to:

> report to the members upon the balance-sheet and accounts and … state whether in their opinion the balance-sheet is a full and fair balance-sheet, containing the particulars required by these regulations of the company and properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs ...

22. However, financial scandals connected with company accounts continued to arise, including the collapse of the bankers Overend, Gurney and Company in 1866 (with allegations of fraud and false statements made in the 1865 prospectus) and of the City of Glasgow Bank in 1878 (where massive losses incurred from speculation and

[18] Table A, paragraph 94.

complicated business transactions in North America and the Far East had been hidden by falsified balance sheets and profit and loss accounts).

23. Such financial scandals raised the issue which had arisen in 1844 and continue to this day—to what extent should audits and auditors be expected to identify fraud, falsified balance sheets and company accounts.

24. In two landmark cases in the 1890s (*In re London and General Bank* (1895) and *In re Kingston Cotton Mill* (1896)) the common law duties of an auditor were clarified. Lindley LJ stated these to be:

> to examine the books, ascertain that they are right, and to prepare a balance-sheet showing the true financial position of the company at the time to which the balance-sheet refers. … an auditor is not an insurer, and that in the discharge of his duty he is only bound to exercise a reasonable amount of care and skill. … what in any particular case is a reasonable amount of care and skill depends on the circumstances of that case; … if there is nothing which ought to excite suspicion, less care may properly be considered reasonable than could be so considered if suspicion was or ought to have been aroused. These are the general principles which have to be applied to cases of this description.
>
> …
>
> Auditors are … bound to see what exceptional duties, if any, are cast upon them by the articles of the company whose accounts they are called upon to audit. Ignorance of the articles and of exceptional duties imposed by them would not afford any legal justification for not observing them.
>
> It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade on hand. In

> the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the balance-sheet. In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by every one who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter.
>
> …
>
> It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to any one before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was.[19]

25. In the same case, Lopes LJ said:

> It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in

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[19] *In Re Kingston Cotton Mill Company (No. 2) [1896] 2 Ch. 279.*

> believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

1900 to 1948

26. The Companies Act 1900 was enacted 'with a view to the better prevention of fraud in relation to the formation and management of companies'[20] and this introduced a compulsory audit for most companies (but not banks) in terms similar to but not identical to those that had been in Table A under the earlier Acts.

27. Directors and officers of a company could not act as auditor. Auditors reported to shareholders 'whether, in their opinion, the balance sheet [was] … a true and correct view of the state of the company's affairs … as shown by the books of the company'.

28. In 1918, Lord Wrenbury's Report on Company Law Amendment considered whether 'auditors must have some and what professional qualification', but made no recommendation as 'We have not traced any mischief which requires remedy in the matter'. The report also considered whether the auditor's opinion should be changed from 'a true and correct view of the state of the company's affairs … as shown by the books of the company', to simply 'a true and correct view of the state of the company's affairs', but considered that 'it would be highly inexpedient indeed, we may say impossible, to require a certificate in that form' and that the London and General

[20] Davey Committee report on *Amendments necessary in the Acts relating to Joint Stock Companies incorporated with limited liability,* June 1895, *C 7779.*

Bank case and the Kingston Cotton Mill case 'have delimited with great distinctness the extents and limits of the auditor's responsibility'.

29. The Greene Committee on Company Law Amendment reported in 1925. The report noted that: 'Many of the suggestions made to us show that the idea that fraud and lesser malpractices can be stopped by the simple expedient of a prohibition in an Act of Parliament, dies hard'. As regards auditors, it stated that 'in general the law as it stands with regard to the powers and duties of auditors is satisfactory'. However, changes introduced by the Companies Act 1929 included a requirement for companies to include a copy of their latest balance sheet, and the auditor's report thereon, with their annual returns to the registrar of companies; and a requirement that auditors could no longer be partners or employes of an officer of the company.

30. The problem of financial scandals linked to balance sheets and accounts continued, including the *Royal Mail Steam Packet Case* in 1931 (falsification by Lord Kylsant of a trading prospectus). This case raised the issue of the practice of secret reserve accounting, ie boosting the declared profits by taking money from secret reserves without declaring this, so implying (or stating) that the profits had come from trading. The 1947 Act made it clear that non-disclosure of this in an audit report was not compatible with the accounts giving a 'true and fair view' as the 1947 Act required.

31. The Companies Act 1948 consolidated the existing legislative provisions. These included the changes made by the Companies Act 1947, following the recommendations of the Cohen Report of 1945.[21] As regards auditing, the important changes were: to restrict eligibility for appointment as auditor to persons possessing recognized professional qualifications or having special experience; to require the auditor to report on the profit and loss account as well as the balance sheet; and to state

[21] *Report of the Committee on Company Law Amendment* (Cm 6695)

whether the accounts give a 'true and fair view' (rather than a 'true and correct view') of the state of the company's affairs and of the profit and loss for its financial year. This change of wording was as recommended by the Cohen report, but without comment or discussion of the reasons for the change. The 1948 Act also provided that auditors could make representations to the company if their appointment was terminated for any reason.[22]

1948 to 1985

32. In 1963, the Rolls Razor collapse showed the limitations of the then current auditing arrangements to deal with the wide variations in accounting practices in use at that time. Rolls Razor was a large-scale supplier of domestic washing machines, but went into liquidation with liabilities of around £3.2 million, despite the last accounts showing net assets of around £1.6 million and profits of £400,000. Similar issues arose in 1967, in the contested takeover of Associated Electrical Industries (AEI) by General Electric Corporation (GEC). As part of its defence, AEI had forecast profits of £10 million for the current year, but once GEC had gained control, it transpired that AEI had a loss of £4.5 million. The difference was explicable in part because of different permissible accounting treatments.

33. In 1970, the ICAEW created the Accounting Standards Steering Committee (later to become the Accounting Standards Committee) which issued standards for financial reporting in an attempt to combat the wide variation in accounting treatments in use at that time.

34. The Companies Act 1976 introduced a provision which requires[23] an auditor who has resigned to make a statement setting out the relevant circumstances (or confirming

[22] Companies Act 1948, section 160.
[23] Companies Act 1948, section 160, merely allowed an auditor to make such a statement.

that there were no relevant circumstances). This statement is not only to be brought to the attention of the members of the company, but also to the attention of the creditors of the company, and is to be deposited at Companies House (and so made public).[24] This appears to be the first time audit provisions had been expressly directed towards the protection of interested third parties (ie not members of the relevant company).

35. The Companies Act 1981 was enacted to give effect to the 4th Company Law Directive on the annual accounts of companies with limited liability.[25] The Directive requires company accounts to follow prescribed formats for the balance sheet, profit and loss account and the notes to the accounts.

36. The introductory recitals state that:

> Whereas annual accounts must give a true and fair view of a company's assets and liabilities, financial position and profit or loss; whereas to this end a mandatory layout must be prescribed for the balance sheet and the profit and loss account and whereas the minimum content of the notes on the accounts and the annual report must be laid down;
> Whereas, however, derogations may be granted for certain companies of minor economic or social importance;
> Whereas the different methods for the valuation of assets and liabilities must be coordinated to the extent necessary to ensure that annual accounts disclose comparable and equivalent information; ….

37. Accordingly, Article 2 of the Directive provides (emphasis added) that:

> 5. Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3,

[24] Companies Act 1976, section 16
[25] 78/660/EEC of 25 July 1978, OJ (1978) L 222.

that provision must be departed from in order to give a true and fair view within the meaning of paragraph 3. Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss. The Member States may define the exceptional cases in question and lay down the relevant special rules.

Thus the duty to give a 'true and fair view' may override the duty to apply accounting standards.

38. The 1981 Act also required auditors to review the directors' report to ensure that it was not inconsistent with the financial statements.

39. These provisions, and other provisions amending the Companies Act 1948 (including the Companies Acts 1967, 1976 and 1980), were subsequently consolidated in the Companies Act 1985.

1989 to 2006

40. The Companies Act 1989 gave effect to the 8th Company Law Directive.[26] It required audit firms to be a member of a recognized supervisory body before auditing a UK registered company,[27] and gave the first UK statutory recognition to the existence of accounting standards.[28] It inserted a new section 256 in the Companies Act 1985, and a new disclosure requirement in Schedule 4 to that Act. 'Accounting standards' were defined as statements of standard accounting practice issued by prescribed bodies; accounting standards applicable to a company's accounts were those which are relevant to a company's circumstances and to the accounts. Schedule 4, para-

[26] Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents (repealed and replaced by Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts—OJ (2006) L 157/87).
[27] Section 25.
[28] Section 19.

graph 36A, required companies to state by way of note whether the accounts have been prepared in accordance with applicable standards, and particulars of, and reasons for, any material departures. (There was an exception for small and medium-sized companies and certain small and medium-sized groups.)

41. The Accounting Standards Board was the prescribed standard-setting body for the purposes of section 256.

42. The 1989 Act also permitted auditing firms to incorporate as limited liability companies. However, it appears that few auditing firms did in fact do so.

43. In 2000, the Limited Liability Partnership Act was passed, which allowed the audit firms to become limited liability partnerships (LLPs). Introducing the Bill, the Minister, Lord McIntosh of Haringey, explained the aim of creating LLPs as follows:

> The limited liability partnership would be a new corporate vehicle to which large portions of the Companies Act will apply, but it would retain certain aspects of a partnership. The LLP would be a separate legal entity from its members and ownership would rest with the members. Members would be free to agree between themselves their relationship with each other and they would be treated as agents of the firm. However, unlike a partnership, the liability of individual members would be limited. Clearly that limitation of liability brings with it certain responsibilities: a need to ensure that the client is fully aware of the nature of the organisation with which they are dealing, and a need to ensure against abuse. As a result, although the LLP offers limited liability to its members, each member will owe a duty of care to his or her clients and, in the event that they are negligent, they will be fully liable to the extent of their personal assets, although fellow 'innocent'

members would have limited liability. Since members would be agents of the limited liability partnership, that partnership itself would also be liable for the actions of its members. Claims could be made against a limited liability partnership to the full extent of its assets.[29]

44. Two financial scandals which then occurred in the USA became a catalyst for change. As the Minister for Industry and the Regions stated when introducing the Companies (Audit, Investigations and Community Enterprise) Bill:

> Part 1 of the Bill will strengthen existing provisions on company accounts and audit, on the regulatory system for auditors and on company investigations in the wake of the Enron and WorldCom scandals. Although those scandals occurred in the United States, they raised fundamental questions about the reliability of the accounting and auditing system.[30]

Enron

45. In 2001, it became apparent that the Enron Corporation in the USA had been using specialized accounting techniques and special purpose enterprises to overstate profits and hide massive losses off balance sheet. Enron subsequently filed for bankruptcy. The Report of the Permanent Subcommittee on investigations of the Committee on Governmental Affairs, United States Senate [2002],[31] found that:

> In 1999, Audit Committee members were given a nine page presentation on mark-to-market and fair value accounting issues, and told how Enron divisions were expanding their use of fair value accounting which 'require[d] continuous revaluation of asset[s] and liabilities' on Enron's books.

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[29] Hansard HL Deb 09 December 1999 vol 607 col 1420.
[30] HC Deb vol2004 c637: http://hansard.millbanksystems.com/commons/2004/sep/07/companies-audit-investigations-and
[31] www.hsgac.senate.gov/download/the-role-of-the-board-of-directors-in-enrons-collapse.

Andersen informed the Audit Committee members that Enron was engaged in accounting practices that 'push limits' or were 'at the edge' of acceptable practice. In the discussion that followed, Andersen did not advocate any change in company practice, and no Board member objected to Enron's actions, requested a second opinion of Enron's accounting practices, or demanded a more prudent approach.

On paper, the Audit Committee conducted two annual reviews of LJM transactions in February 2000 and February 2001.[32] In reality, these reviews were superficial and relied entirely on management representations with no supporting documentation or independent inquiry into facts.

46. The report included findings that:

The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.

The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor.

[32] LJM were private equity funds which transacted business with Enron.

WorldCom

47. On 25 June 2002, the US telecommunications company WorldCom announced that it intended to restate its financial results for all the quarters in 2001 and the first quarter of 2002 and filed for Chapter 11 bankruptcy protection the following month in what was the largest bankruptcy filing in the USA to that date.

48. The US Securities Exchange Commission filed a complaint against the company for various breaches of the Securities Exchange Act of 1934 and claimed that WorldCom had misled investors from at least as early as 1999 through the first quarter of 2002, and that, as a result of undisclosed and improper accounting, WorldCom had materially overstated the income it reported on its financial statements by approximately $9 billion.

Sarbanes–Oxley

49. The response in the USA to these, and other, financial scandals[33] was adoption in 2002 of an Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes, sponsored by Senator Paul Sarbanes and Representative Michael G Oxley.[34]

50. The Sarbanes-Oxley Act, among other things, created a private body with regulatory functions, the Public Company Accounting Oversight Board (PCAOB), to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. Under section 101 of the Sarbanes-Oxley Act, the PCAOB has power (among other things) to:

- register public accounting firms that prepare audit reports for issuers;

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[33] Such as Tyco (where the former Chairman and Chief Executive and the former Chief Financial Officer were convicted of theft from the company, and Tyco settled a class action by agreeing to pay $2.92 billion, and its auditors agreeing to pay $225 million, to a class of defrauded shareholders).
[34] Public Law 107–204; Sarbanes-Oxley Act 2002.

- set auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports by issuers;
- conduct inspections of registered public accounting firms;
- conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms (including fines of up to $100,000 against individual auditors, and $2 million against audit firms);
- perform such other duties or functions as the board (or the US Securities Exchange Commission) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and their employees; and
- sue and be sued, complain and defend, in its corporate name and through its own counsel, with the approval of the US Securities Exchange Commission, in any Federal, State or other court.

Regulatory developments

51. The UK did not follow the US model of creating a body to oversee the audits of public companies in order to protect the interests of investors. However, Part I of the Companies (Audit, Investigations and Community Enterprise) Act 2004 strengthened existing provisions on company accounts and audit on the regulatory system for auditors and on company investigations. The 2004 Act placed new requirements on the five recognized supervisory bodies of auditors[35] by making it a condition of recognition that they participate in independent arrangements for setting auditing standards relating to professional integrity and independence and setting technical standards; for monitoring audits of listed companies and other companies whose financial condition is of particular importance; and for investigating and taking disciplinary action in relation to public interest cases.

[35] ie ICAEW; ICAS; ACCA; ICAI.; and the Association of International Accountants.

52. The 2004 Act also extended the power of the Secretary of State to provide funding to bodies such as the FRC for setting accounting and audit standards (through the ASB and the Auditing Practices Board (APB)); for enforcement or monitoring (through the FRRP, the Accountancy Investigation and Discipline Board (AIDB), and the audit inspection unit reporting to the Professional Oversight Board for Accountancy (POBA)); and for oversight of the major professional accountancy bodies (through the POBA). Under recent FRC reforms, approved by the Government in 2012, the FRC has made significant changes to its operating structure, and now operates through two main committees: Codes and Standards, and Conduct. See further Appendix 8.

53. In 2004, following the DTI report, *Review of the Regulatory Regime of the Accountancy Profession*,[36] the APB assumed responsibility for setting standards for the integrity, objectivity and independence for auditors and issued five Ethical Standards for Auditors. These cover the integrity, objectivity and independence auditors should apply in the audit of financial statements, and have been revised in 2010 and 2011.[37]

54. Examples of the steps now taken by FRC include the following:

(a) annual inspections of the large audit firms to:

- test whether the firms have established an appropriate control environment fit to deliver high-quality audits;
- test individual listed company audits for effectiveness in the companies' application of accounting standards; and
- test whether audit evidence has been gathered and documented in accordance with Auditing Standards;

[36] www.bis.gov.uk/files/file20686.pdf.
[37] Ethical standards for auditors.

(b) public reports on each inspected firm's perceived quality performance and letters to the AC of each audit inspected;

(c) publication annually by each large firm of a transparency report describing a range of matters that are seen as relevant to the public interest; and

(d) appointment of independent non-executives (INEs) whose remit covers all the business activities of the firm by reference to certain prescribed aspects. INEs have a regular, private dialogue with the FRC.

55. The Secretary of State was given power by the 2004 Act to make regulations addressing issues of independence, by requiring companies to publish more information about the types of services they and their associates have purchased from their auditors and associates. A loophole—that it was not a criminal offence for an officer of a company to fail to provide information or explanation to an auditor—was also dealt with. Further strengthening of audit arrangements was made by giving the Financial Reporting Review Panel Ltd (FRRP) power to require information to be provided to it.

The Audit Directive

56. In 2006, to deal with the issues raised by Enron and WorldCom[38] and by the Parmalat scandal in Europe, the EU replaced its 8th Company Law Directive with a revised version of the Directive.[39] The Directive aims at a high-level (though not full) harmonization of statutory audit requirements and largely reflects best practice for statutory audit as already existed in the UK at that time. These provisions have been given effect by the Companies Act in the UK.

[38] In the USA this was done by the Sarbanes–Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745).
[39] 2006/43/EC (replacing the Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents) OJ (2006) L 157/87.

57. The Audit Directive expands and replaces the Eighth Council Directive on Company Law (which only dealt with the approval of statutory auditors) by clarifying the duties of statutory auditors, their independence and ethics; by introducing a requirement for external quality assurance; and by ensuring public oversight over the audit profession (most of which had already been in place in the UK, especially following the 2004 Act). The APB issued its Ethical Standards in December 2004,[40] dealing largely with the independence of auditors.

58. The Directive clarifies that a group auditor bears full responsibility for the audit report on the consolidated accounts of the company (a principle that had long been reflected in UK auditing standards). As regards' PIE (ie broadly, entities such as credit institutions, insurance companies and investment firms which are of significant public interest because of their business, size, number of employees or their corporate status), the Directive requires that the AC must monitor the effectiveness of the company's internal control, internal audit (where applicable) and risk management systems. Also only non-audit practitioners can participate in the governance of the system of public oversight of the auditors of public interest entities.

59. Auditors must have knowledge of the relevant accounting standards on which the financial statements have been prepared and international standards on auditing (ISA (UK and Ireland)). In the case of PIE, the AC is involved in the selection of the statutory auditor which is proposed to the members for appointment; and the statutory auditor or audit firm must report to the AC on key matters arising from the statutory audit, including material weaknesses of the internal control system in relation to the financial reporting process. Threats to the auditor's independence must be disclosed to and discussed with the AC, and the auditor must confirm his or her independence in writing to the AC.

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[40] Revised Ethical Standards were issued in 2010.

60. Member states must ensure that adequate rules are in place which provide that fees for statutory audits are not influenced or determined by the provision of additional services to the audited entity. In the UK, these rules have been implemented by means of detailed ethical standards issued by the Auditing Practices Board.

61. Article 31 of the Audit Directive invited the European Commission to present a report on the impact of current national liability rules for carrying out statutory audits on European capital markets. Following an independent study[41] and a consultation, the European Commission published a recommendation in 2008[42] that the civil liability of statutory auditors, and of audit firms, arising from a breach of their professional duties should be limited, except in cases of intentional breach of duties by the statutory auditor or audit firm. In the UK, the Companies Act introduced the concept of 'limited liability agreements' which may be agreed between the auditor and the members (shareholders) of the company to limit the auditor's liability.

The banking crisis

62. The banking crisis in 2008 highlighted that an expectation gap (ie between what auditors provide and what stakeholders expect to see) remained in the audit system.[43] Notwithstanding serious intrinsic weaknesses in the financial health of the relevant companies, the audits of those companies, carried out immediately before, during and following the crisis, had resulted in unqualified audit reports.

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[41] *Study on the Economic Impact of Auditors' Liability Regimes*, September 2006: http://ec.europa.eu/internal_market/auditing/liability/index_en.htm.

[42] Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms, OJ (2008) L162/39: http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2008:162:SOM:EN:HTML.

[43] The ICAEW Report: *Audit of Banks—Lessons from the Crisis* (2010) states:

> The audit report itself, however, was not viewed as providing useful information to users. It was variously described as a statement of compliance with accounting standards and lacking in information content, since unqualified audit reports use standardised wording. … With the growth in size of annual reports and financial statements, it has become more difficult for users to identify the key areas of judgement or risk. Audit reports have always been an opinion on directors' presentation of the financial statements, rather than a wider business commentary.

Audit of Banks, 2010.

63. In November 2011, the European Commission issued a proposal for a regulation to increase the quality of audits of public interest entities, and for a directive to enhance the single market for statutory audits. Key elements of these proposals (which may be modified before any final approval) include:

(a) *Mandatory rotation of audit firms.* Audit firms required to rotate after a maximum engagement period of six years (with some exceptions). A cooling-off period of four years is applicable before the audit firm can be engaged again by the same client. The period before which rotation is obligatory can be extended to nine years if joint audits are performed.

(b) *Mandatory tendering*. PIE obliged to have an open and transparent tender procedure when selecting a new auditor; the AC to be closely involved in the selection procedure.

(c) *Non-audit services*. Audit firms prohibited from providing non-audit services to their audit clients. In addition, large audit firms obliged to separate audit activities from non-audit activities in order to avoid all risks of conflict of interest.

(d) *European supervision of the audit sector*. Coordination of auditor supervision activities to be within the framework of the European Markets and Securities Authority.

64. In July 2012, the Companies Act was amended by statutory Order,[44] which reimplemented obligations in the Audit Directive[45] by giving the Secretary of State new powers to secure that the relevant accountancy professional bodies discharge their responsibilities as regards the authorization and supervision of 'statutory auditors'. It also replaced the exisiting delegation of functions of the Secretary of State under Part 42 of the Act concerning auditors with a new delegation in favour of the FRC.

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[44] The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012 (SI 2012 No. 1741).

[45] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EC and repealing Council Directive 84/253/EEC.