

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Company A

Background

1. Company A (the company) was a FTSE 250 business in the [X] industry. It had a presence in a large number [X] of countries across Europe, Asia, North America, Latin America, the Caribbean and Australasia.
2. Until mid-2011, the company was in the FTSE 100 index, and had a market capitalization of around £[X] billion at the time of interview. In the year ended 2011, the company had revenues of £[X] billion and profit after tax for the year of £[X] million.
3. Company A's parent company had a majority shareholding of [X] per cent. All but one of the other major shareholders were institutional investors.
4. The company was formed in [X] following the merger of [X] and the parent company's equivalent business with [X] listed on the LSE. The merging parties had been audited by different Big 4 audit firms. [X]
5. Following the merger, there was an audit tender for the company between the two Big 4 audit firms who audited the predecessor businesses. The audit of the parent company did not go out to tender. [X] was appointed to audit the company. The audit arrangements for the underlying subsidiaries worldwide initially remained unchanged resulting in [X] and [X] undertaking subsidiary audits reporting to [X] as Company auditor, who in turn reported to [X] as parent company auditor. [X].
6. In [X], the company discovered an accounting error which led to a restatement of the [X] Financial Statements (for both the company and the parent company). This resulted in a write-down of £ [X] million. The previous auditors, following completion of the audit of the 2010 financial statements, did not seek reappointment as auditor, citing the breakdown of its relationship with certain directors.
7. The previous auditor's resignation letter dated [X] stated:

We have had extensive discussions with the directors of the Company over the background to these restatements, the implications arising from them and their disclosure and accounting treatment in the financial statements. Over the course of these discussions our relationship with certain directors became increasingly strained. As a result we are not confident that in future we could carry out an audit of the Company to the appropriate standard, but others may be able to do so. Accordingly we have not decided to seek reappointment as auditors of the Company.
8. For this case study, we did not interview the former CFO and former ACC who were in position at the time of the restatement and 2010 audit by the previous auditor.
9. The auditor of the parent company was appointed as auditor for the company in 2011 and took over all auditor relationships with the company in the UK and the majority of other countries.
10. The audit fee as disclosed in the 2011 accounts was £ [X] million. The comparable figure in 2010 (ie that paid to the two separate audit firms) was £[X] million.

The current CFO's view

11. The CFO was appointed in [X]. He had previously served on the company's Board as Commercial Director.
12. He trained as a Chartered Accountant at a Big 4 firm and spent approximately seven years there, primarily as an auditor. He then worked for a variety of businesses in Finance Director roles. During his career, the audit firms the CFO had worked with were 'all of them, well, all the big ones'. He had worked with Mid Tier auditors where they had acted as auditor for smaller subsidiaries around the world.

Relationships

Auditor

13. The CFO met with the AEP every three weeks all year around. He explained that the reporting cycle never stopped as the company reported quarterly. There were ten Audit Committee meetings a year and the AEP attended all of these. The CFO had a briefing with the AEP before each of these. His discussions with the AEP tended to be around judgemental areas and accounting issues rather than the detailed audit process.
14. The Group had major divisions in Central, Western and Northern Europe. The CFO met the partners responsible for these areas as well as the partners responsible for certain sectors of the business.
15. The company received Management Letters from the auditor on every operating entity where it was the auditor—these reported on the internal control environment.

Audit Committee Chair

16. The CFO met the ACC before the Audit Committee papers went out. The ACC came in for a day, sometimes two days, and sat with the people who had prepared the papers (auditors, legal, internal finance) to check that he was happy with them. Only then were papers sent to the rest of the Audit Committee. As well as at Board meetings and Audit Committee meetings, the CFO also saw the ACC at a quarterly dinner that was held for the CFO, the Senior Independent NED, the CEO and the ACC.
17. The CFO said that the ACC had put a lot of effort into the role since joining the Board. He was very keen and provided high quality and timely advice. The Board appreciated the work that he had put in. The ACC had had to learn the industry but seemed to have liked the interaction and the challenge.
18. There were around 900 statutory entities in the group, not all of which required an audit. An area the ACC had focused on was ensuring that the business understood what proportion of its revenue, profits and balance sheet was audited in full, and how much was audited on a rotational basis. He wanted to make sure that over a period of time every business unit was seen on a regular basis by somebody external. He had pushed for more transparency to aid debate of the issues.

Shareholders

19. The CFO saw two of the parent company directors quite a bit as they attended the Audit Committee meetings. When he saw other shareholders there was very little discussion of the audit; the focus of these meetings was business performance.

Resolution of audit issues

20. This year the company's focus was on quality. The CFO wanted to ensure transparency and if there was an issue over accounting treatment he was happy to defer to the auditors.
21. There had been issues in the UK regarding the control environment. Over the last 10 to 15 years, the company had acquired a number of businesses and uniform controls had not been implemented. There was now a programme underway to rollout a standard control framework and documentation (COSO).
22. The audit approach had been adjusted to reflect the issues in the control environment. Previously reliance had been placed on these controls. The CFO said that he did not wish to see reliance to be just on the controls. He wanted the auditors to 'bash the balance sheet'. Significant effort had been put into this during the 2011 year-end audit.
23. In terms of reporting audit issues, the CFO explained that anything related to fraud had to be notified directly to internal audit, and then the ACC would be informed directly by internal audit. If there were other issues, these would be reported through draft or final audit reports. Findings were rated on a scale of 1 to 3, with 1 being a priority issue (ie something to worry about) and 3 being a 'to be aware but of nothing to worry about' issue.
24. The CFO said he spent about half a day to a day a week on audit related matters. He would spend most time around the year end, this reduced for the half year and quarterly reporting and during the rest of the year it would be less. He met the head of Internal Audit every week.
25. The CFO said that the audit process was important from a management perspective as it provided an external view of the controls and balance sheet to help management ensure they were in good order. This benefited the Board and shareholders.

The previous accounting issues

26. The CFO said that it was difficult to get to the bottom of the issues. The business went through a significant merger in [redacted] and as a result, the finance function was moved to a shared service centre in a new location. Many experienced staff did not move with the business and there was little or no documentation of controls.
27. The issue arose as different systems did not reconcile automatically with each other. [redacted]
28. The current auditor had undertaken the [redacted date] audit. They were not happy with the reconciliation but on a global level thought that errors were not material. The previous auditor took a similar view the following year and considered the issues would still not be material. However the ultimate result was a £[redacted] million discrepancy in the balance sheet, leading to a write-off of £[redacted] million. The CFO noted that this should

be considered in the context of a business that processed approximately £[X] billion worth of transactions each year.

29. The CFO did not attend the Audit Committee at the time (he was on the Board in a different role). However, he was brought into some of the meetings as he had a good understanding of the history of the business and how it worked.
30. As a result of the issues a number of the company's Directors left the company. [X]
31. The CFO was disappointed that the previous auditors had not picked up these issues as being more material, but he could see how this had happened as the issue was so complex.

The change of auditor

32. The previous auditor fell out with the parent company directors during the process of resolving the accounting issues. In addition, the CFO considered the situation with different audit firms auditing the parent company and the company was too complex. He explained that it resulted in one firm reporting to the other firm which then reported back to the first firm (sometimes this involved reporting back to the same people). Given this, it was sensible to have just one auditor to make the process more efficient (and cheaper).
33. The auditor of the parent company was appointed as the company auditor and the company was happy with this. The new AEP was experienced in the sector and whilst he had recently audited a competitor this was not a concern to the company. The concerns over the quality of the audit that the new auditor could provide were around the company's own internal control weaknesses. The audit approach was altered to focus on the balance sheet rather than relying on controls

Switching triggers and costs

34. The CFO said that both costs and quality could be triggers for switching, and he ranked quality above costs. It was important not to have too cosy a relationship and companies needed to tender regularly to keep costs down.
35. The Audit Committee, led by the ACC, would make recommendations to the Board, for shareholder approval, on any change in auditors. In practice, this would be instigated by a recommendation from the CFO and ACC together. The CFO said that switching costs would not affect a decision to change auditors. He said that the cost was really on the audit firm's side. The internal time from the company's perspective in terms of getting the auditors up to speed would be spread across a number of companies and offices and so the burden on any one team would not be too great.

Awareness of other options

36. In terms of approaches by other firms offering to undertake the company's audit, another Big 4 firm had approached the ACC, but generally the Big 4 firms knew that if a firm had been appointed it would have three to four years in position unless something happened. Switching more frequently would be sub-optimal.
37. The CFO considered that a Big 4 auditor was needed for the company due to the sheer scale and complexity of the business. The company faced no restrictions within the Big 4. The CFO was aware that the ACC felt that one of the Big 4 firms was too close given his previous role, but the CFO did not have the same reservations. The

same audit firm provided tax advice to the company. He considered that he had sufficient choice within the Big 4 firms.

38. The CFO had used the Mid Tier firms for other (non-audit) assignments and thought that they did not have the geographic scope that the company required. He had not received any marketing material from them. In addition, he said that his views on the Mid Tier were based on his seven years experience as an auditor. Whilst there had been many changes since then he felt the Mid Tier had stayed as the Mid Tier.
39. The choice of audit firm was important but more important was the AEP and the team that would be delivering the work.

Fees

40. Fees were negotiated by the CFO and signed off by the Audit Committee led by the ACC. The ACC's recent experience as an auditor was helpful as he knew what firms charged.
41. On a like-for-like basis, the company was paying around 10 per cent less to its current auditor than it had to the previous auditor, as there were efficiencies for the audit firm in auditing both the company and the parent company. However, this year the company (led by the ACC) had pushed for higher scope and so the company had incurred more costs.
42. The company did not want to over pay but quality was key and so the company was happy to pay more this year. The additional scope was for certain business units where an audit was not required from the group audit perspective but where the company wanted additional assurance from the auditors.

Quality

43. The feedback received from the business on this year's audit was good. Some business units reported that they felt like they had been audited [X].
44. The company had identified parts of the business where the quality of the audit partner was not as good as they wanted and so the CFO had spoken to the AEP and the auditor agreed to provide a new partner for those areas next year. This new partner would also attend the Audit Committee meetings to report on this change. Feedback was two-way. The CFO received feedback from the AEP on the quality of his FDs in the business.
45. The CFO noted that the AEP had previously audited businesses in the same industry, which helped.
46. The CFO considered that audit partner rotation was too frequent. He thought that he received better advice the longer the partner had been in the role, but he also considered partner rotation was necessary as he did not want too cosy a relationship.

Non-audit services

47. The current auditor was used where best placed, for example on work where technical accounting was required and where another firm would take time to get up to speed. The current auditor was also being engaged to roll-out the COSO framework (internal controls framework).

48. Most non-audit work was tendered to two or three firms. The start point was that the auditors should not be used which meant that, for some work, the auditors missed out even when were well placed.

The current Audit Committee Chairman's view

49. The ACC [X] joined the Board in [X date], after the appointment of the current auditor. The ACC was previously a senior audit partner with a Big 4 firm and a member of the Audit Practices Board. The ACC thought that in general FTSE Boards would prefer to appoint a former Finance Director to the ACC role due to their business experience and strategic outlook, but, in the case of the company, a chartered accountant or auditor was wanted as the internal controls had not been good and the company required someone with sufficient auditing experience to correct this.

Relationships

Auditor

50. There were 10 Audit Committee meetings per year for which the ACC set the agenda. The auditors attended all Audit Committee meetings during the year, although there was part of one meeting where they were not present in the room. The ACC had also seen the audit partner twice informally in a social-type environment since joining the company. The ACC reviewed all draft papers, including those relating to accounting judgements, before they were presented to the rest of the Audit Committee. The ACC had had lunch once with the audit firm's Senior Relationship Partner. The ACC considered that meeting this partner once a year was appropriate.
51. The ACC explained that the half-year and full-year reporting periods were more intense periods of Audit Committee and Auditor interaction. For example, at the Audit Committee meeting prior to the half-year report, the auditors would have up to 30 minutes but more likely no more than 15 minutes (out of a three-hour meeting) to present a short paper, whereas at the year-end they would have up to an hour (out of a four-hour meeting).

Management

52. There were quarterly dinners between the ACC, CFO and Chief Executive and Senior Independent Director. The ACC expressed a preference for these meetings to be held informally. The ACC also met with the CFO once a month with conversations taking place in between as necessary.

Shareholders

53. Since appointment, the ACC has held meetings at the request of three shareholders. One [X] requested a meeting to discuss the appointment of the current auditor following the previous auditor's resignation. The other two shareholders wanted to discuss the appointment of the current auditors and the steps being taken to improve financial controls.
54. The parent company received the company's management information and the parent company's Finance Director normally attended the company's Audit Committee meetings by invitation. Any technical accounting matters needed to be

agreed by the parent company's and the company's auditor. The ACC saw his role, in part, as a non-executive to be protecting the smaller minority [%] per cent shareholders. For example, if there were a takeover bid from the parent company, then the non-executives were there to ensure that the other shareholders got a fair price.

Resolution of audit issues

55. On appointment, the ACC had anticipated spending 20 to 25 days a year on the company, but due to the control issues which needed to be resolved he had spent a little more. The ACC felt he had sufficient resources to scrutinize adequately the audit process. He said he had enough access to the CFO and CEO and with regards to his own time: 'definitely I have enough time, or else I would be a mug to do the job!'
56. The ACC's opinion of the auditors was that first time through, they had done a pretty good job and they had thrown a good independent perspective on one or two things. As an example he noted that the auditors had challenged the model the company used to calculate goodwill and thought that they had a good understanding of how this linked to market capitalization.

Auditor selection

Switching auditors

57. The predecessor businesses were audited by two different Big 4 firms when the company was formed by the merger of [%]. The company held a formal tender process in [% date] and one of these Big 4 firms was appointed sole auditor (although the other Big 4 firm continued to audit a number of subsidiaries).
58. In [% date] an accounting issue, where accounts were not reconciled properly, was found but was not thought to be material by the previous auditor. Subsequently it was found to be a considerable issue, resulting in a £[%] million write-off [%]. Following the previous auditor's decision not to seek reappointment (the ACC's understanding was that there was a falling out between certain of the majority shareholder's directors and the auditors), the audit was given to the other Big 4 audit firm, which the ACC thought made sense given that the parent company used the same auditor and therefore the auditor needed to be comfortable with the audit of the company in any event. The ACC said that if the parent company had not had a [%] per cent shareholding then it was likely a tender would have been held.
59. The ACC said that until [% date] the UK business was audited by one audit firm reporting to a different audit firm and it was unclear exactly when the internal controls went wrong and whether the current auditor in its previous role should have spotted this during their tenure. The issue was identified in [% date] and flagged and reported but the previous auditors concluded it was not likely to be material. Then it turned out to be worse than they had thought.
60. The ACC told us that the auditor effectiveness review would be carried out annually, in accordance with the UK Corporate Governance Code. This sought the views of management and the Audit Committee on the audit process seeking a rating between one and five on the following areas:
 - (a) robustness of audit process, including:
 - (i) dialogue on independence;

- (ii) auditors hold a dialogue on their internal quality control procedures;
- (iii) auditors demonstrate understanding of business risks, issues and their impact;
- (iv) auditors report on internal controls and make constructive recommendations;
- (v) auditors present a clear and appropriate audit strategy;
- (vi) auditors make effective use of the work of internal audit or say why not;
- (vii) auditors exhibit professional scepticism in their work;
- (viii) auditors hold private meetings with the Audit Committee; and
- (ix) auditors properly evaluate management's assessment of going concern;

(b) quality of delivery, including:

- (i) auditors have a constructive working relationship with management;
- (ii) auditors deliver an efficiently executed audit with all deadlines met;
- (iii) auditors are appropriately resourced to address important audit concerns;
- (iv) significant accounting judgements are clearly explained;
- (v) timely raising of issues; and
- (vi) communication deviation from audit plan are clearly explained;

(c) quality of people and service, including:

- (i) the audit team—integrity, good judgement, professional scepticism;
- (ii) technical knowledge;
- (iii) experience of the audit team;
- (iv) succession plans for rotating off partners;
- (v) clear roles and responsibilities for audit team members;
- (vi) expectations are agreed at the outset and have been met;
- (vii) perceptive, practical and effective recommendations are made; and
- (viii) international coordination is effective,

61. The ACC said that the 2011 review had shown the audit to be generally completed effectively but that there was room for improvement in the Specialist and Activity Sector and tax and treasury had received low scores. He rated the auditor at six out of ten and felt that, for a first year audit, they had done pretty well and he would have been surprised if they had done better: 'having done a number of first-year audits as an auditor, they are scary because you do not know everything, and you just do not know who has got what angle within the management of the company until you get to know them and work with them'.

62. From the ACC's point of view, the AEP had done an excellent job, he was cool-headed, technically able and very sensible. The ACC considered this to be a unanimous view of the Audit Committee.
63. The FRC report on the current auditor was also tabled at an Audit Committee meeting and the Audit Committee wanted to understand how an audit receiving a low rating would affect the AEP's remuneration.

Other options

64. The ACC considered that only one of the Big 4 firms (as opposed to a Mid Tier firm) could be considered for the audit. He said that: 'if you went today to a Mid Tier firm and there was something bad in your accounts, the shareholders would be saying, "Why on earth did you not have the Big 4?" because they just, in my experience, do not have the breadth of knowledge.' He explained that this view was influenced by the fact that the company operated in many countries (in Europe, America and the Caribbean and America). He did not think the Mid Tier firms had the reach or the extent to be able to deal with this geographic spread. The ACC added that he was not sure if this view would still be valid for firms with simple operations solely in the UK.
65. The ACC said that his view of the Mid Tier firms was based on the original FRC reports, which, in the first year, found that the Mid Tier firms were not as strong as the Big 4 firms. He did not know if they had improved since then. He said that if the company went to tender then of course they would have the debate as to whether to invite a non-Big 4 firm but his inclination was that this would be a waste of time.
66. At the present time, the company faced a choice between two Big 4 audit firms [X] for its statutory audit. The previous auditor [X] did not wish to be reappointed, and the other Big 4 firm [X] provided a reasonable amount of non-audit services. For this audit firm, the ACC thought it would look awful for his old firm to be appointed as auditors soon after his own appointment to the Board. However, this would diminish as an issue over time.
67. A Big 4 firm [X] had approached the ACC offering to undertake the audit shortly after his appointment, but in the ACC's opinion this was too early. With regards to future tender plans, the ACC thought that a detailed look would be needed within the next ten years, but 'if it ain't broke you don't have to fix it'. The ACC thought having a top firm doing top-quality work and using the auditor effectiveness review properly was a better way to focus efforts rather than changing auditor for the sake of changing.
68. The ACC thought that five years was too short a period for compulsory partner rotation for a company of the company's size, preferring a minimum period of seven years, and that it took two years to understand fully and build relationships with the right people. He noted that when on the board of the Audit Practices Board he, along with companies, had argued strongly for a seven-year period, but that shareholder groups such as [X] had pushed to maintain the current shorter timeframe of five years.

Fees

69. The audit fee was negotiated by the CFO and approved by the Audit Committee. The Audit Committee's concern was achieving value for money and whether the fee was sufficient to do the job properly. He had made a point of asking the AEP whether the

fee was high enough to do a quality job before approving it. From the Audit Committee's perspective, the focus was about quality and getting it (the audit) right, because another restatement in this business would be disastrous.

70. The fee was negotiated on an annual basis and was benchmarked against other companies in the sector, for example [X]. The ACC noted that comparisons with peers were never accurate but gave an idea (the risks may be similar but it was difficult to know how many statutory entities there were that needed opinions signing etc). He mentioned the Accountancy Age survey of audit fees.
71. The ACC thought that there had been about a 10 per cent fee decrease with the appointment of the current auditor compared to the fee under previous auditor, even with the risks associated with the internal controls.

Quality

72. As mentioned in paragraph 59 an auditor effectiveness review was conducted annually, completed by both management and the Audit Committee.
73. The aspects of quality the ACC highlighted included knowledge and experience of the business, managing the audit process well, spending time with management and with staff below the CFO level (to include the Financial Controller and Head of Internal Audit), producing good written reports and doing things in a timely manner. He said that with a good quality audit you 'get a warm feeling that the two or three people in the room know what they are talking about, are balanced and are sensible'. The ACC pointed out that he, and the rest of the Audit Committee, wanted relentless assurance and that this came from both internal and external audit.
74. The ACC thought that the AEP had done well in the most recent audit. Given the complicated nature of the business, he did not expect that the process would be perfect in the first year, but would expect improvements in the second year. A hindsight measure of quality (ie history) was important: whether an error was found after the accounts were signed or no errors were found. The criteria on which the management was asked to report in terms of whether the auditors had done a good job are set out in the Auditor appraisal questionnaire (see paragraph 59).
75. The ACC said that the CFO had a similar view to his own on aspects of quality as he was keen to avoid another black hole in the company's accounts.
76. The ACC said that a long-term relationship with the auditor helped, but only where the auditor was doing good quality work. If the auditors did poor quality work, then the Audit Committee would change them. The ACC thought that changing auditor was risky, especially in the first year of appointment where the auditor had to familiarize itself with the business and management.
77. The ACC said that the AIU had reviewed the company's audit by the previous auditor who had given a clean opinion. He said that the only issue raised in the letter was in connection with the accounts finalisation process. The AIU letter addressed to the previous auditor had been shared with the then CFO and the then ACC and was raised at an Audit Committee meeting. As a result, changes were made to the accounts finalization process for the following year-end. Both the company and the previous auditor took steps to address the issue. The AIU, in a subsequent letter noted that the number and significance of changes made between the signing of the audit report (ie the preliminary announcement) and the publication had reduced significantly.

78. With regard to the first AIU review, the ACC explained that he did not think the AIU had looked at the files of the UK business, and that it may have been a narrower review that covered goodwill and something else, so one would not expect the AIU to have found the accounting issue. Indeed, based on subsequent events, it was not clear whether the circumstances that were identified during the [redacted] audits existed at the time of the AIU review. The ACC noted that the AIU report was a cold review and done solely through the eyes of the audit file.

Non-audit work

79. The company had a policy where the non-audit services provided by the auditor were limited to 100 per cent of the audit fee. In addition, work with a value between £50,000 and £250,000 had to be approved by the ACC. Work over this value had to be approved by the Audit Committee as a whole. All work had to comply with ethical standards.
80. The ACC said that work such as due diligence on small companies should be done by the companies' auditors as they knew how the business worked and would be more likely to provide a stronger team for the work: the auditor was more likely to provide an A team not a B team. He considered that tax compliance work could be provided by the auditor and saw some advantages in this as there was one point of contact if something was not happening as it should. The ACC was against provision of exotic tax schemes by the auditor. He noted that this was far less common across the market.

The current AEP's view

81. The AEP had trained with his current audit firm. He joined the firm from university in 1980. He had been a partner since 1992 working in a variety of offices in and around London primarily in the [redacted] industries. He had audited [redacted] in the late 1990s before it was acquired by the parent company and another business in the sector [redacted] from 2006 to 2010. He had further industry expertise through auditing smaller companies in the industry, as well as undertaking due diligence work prior to acquisitions of such companies and he had worked as part of the audit firm's teams auditing companies in the same industry [redacted] in Kenya, South Africa and Ireland. He had also undertaken the Reporting Accountant work on part of the parent company during the merger [redacted] that formed the company.
82. The company was currently the AEP's only FTSE 350 client. In the past he had been involved as partner in two other FTSE 100 audits and around three FTSE 250 clients and another seven or eight either AIM or small cap listed companies. He had also been the Quality Review Partner on about ten listed companies including one in the FTSE100 and several in the FTSE 350.

The accounting issues

83. The AEP explained that coming in as a new auditor to a company that was known to have a weak control environment in a particular part of the business (the UK division), he had to be aware of the issues, recognize the risk and address this through the quality of the team selected to work on the engagement. He explained that 15 months ago he did not have the same depth of knowledge that he had now about the control environment across the company [redacted].
84. It was the AEP's understanding that the previous auditor was asked to stand down in autumn 2010, after they completed the 2010 audit. However, the parent company

and its auditor were concerned about the accounting error too [X] and so both firms were involved in untangling the issue prior to the completion of the 2010 audit. This meant that the Boards of both the company and the parent company saw the two audit firms in action and were able to see both firm's approaches to the issues. The AEP's reflection was that in hindsight perhaps his firm's approach to that situation—recognizing the scale of the issue and working to find solutions for the company in terms of presentation and lessons learnt—worked better in the eyes of the company and parent company's management Boards than perhaps the previous auditors approach did.

Relationships

85. The AEP said there was a balance to be struck in any audit relationship, as the audit partner needs to establish a good working relationship with management as well as with the ACC and the NEDs. It was necessary to have a good relationship to understand an individual's motivations, as well as simply having a formal dialogue with them. However, the auditor needed to maintain independence. Accordingly this was a balancing act between the three parties (auditor, management, ACC) which formed a triangle.
86. Day-to-day, the AEP's audit relationship was with the CFO and the finance team, and to a lesser extent the CEO (to understand what is going on within the business month by month). There also needed to be a relationship with the non-executive ACC, who primarily represented the shareholder's interests. The ACC did not receive the same level of information as the auditor and so the auditor needed to consider which information that it obtained needed to be transmitted to the ACC.
87. There was a tension in the triangle relationship since, if the auditors were to share observations with the ACC but not with management, the relationship with management might break down making the auditors' role more difficult. Communication therefore needed to be managed properly so that the auditor had a good working relationship with management and could get under the skin of the company.
88. This was not just about picking up some numbers and confirming them against underlying records. Auditors needed to understand how a set of numbers were put together and what motivated the team who produced them. The auditor needed to understand this so he knew where the management team might have placed their cards in terms of the range of possible answers ie whether they had taken an aggressive or conservative approach. This could only be done if the auditor really understood what was going on in terms of the way the management team were actually running the business, the issues they were facing, the pressures they were under, the pressures the non-executives were putting on them, the pressures the shareholders were putting on them, and the structure of the bonus scheme.
89. The AEP explained that management would always form a view themselves. It was their responsibility to form a view as to what an appropriate position might be within a range of acceptable answers. The AEP's job as an auditor was to be sceptical about this view, consider its motivations and possible alternatives.

ACC

90. The ACC had recently retired from another large audit firm [X] and therefore fully understood the role of an auditor in a large FTSE audit. He had experience and

expectations as to how the AEP should behave and act as an auditor of a company this size.

91. The AEP said that an effective ACC spent time and effort in understanding the risks and issues that the business faces. In the case of the company, the ACC had clearly put a lot of effort into getting under the skin of the business and had focused on ensuring the company addressed the control issues it faced.

Shareholders

92. The AEP explained that the relationships at the company were unusual as there was a majority shareholder with representatives who sat on the company's Board, so he did have interaction with them: 'normally in a listed company audit you are dealing with a series of shareholders who are actually invisible to you; they are clearly there, but they are invisible to you'.
93. The AEP had no formal interaction with shareholders, other than attendance at the AGM. In the first year, at the ACC's request, the AEP met with an institutional shareholder [X] half an hour before the AGM to discuss the appointment informally.
94. The AEP said the role of the auditor was to report to the shareholders, as an independent view, on the results and financial position of the company at a particular point in time or over the previous 12 months. The auditors were there to protect the interests of shareholders, who did not have the privilege of being able to see what was going on day-to-day within the company, and the privilege the auditor had was that it had access to any part of the business it wanted to go and see.

Resolution of audit issues

95. The company was implementing COSO—a framework for ensuring good internal controls. The auditor had been involved in explaining to the company what progress needed to be made and what frameworks could be used to achieve this. The auditor introduced a partner who specialized in this work to explain the options to the company. The auditor had been appointed to assist in the implementation of the COSO framework across the group.
96. The AEP explained that a lot of changes in judgements and treatments to transactions and balances in a set of accounts were not seen publicly. These might involve shifting judgements from an unreasonable to a reasonable place, improving disclosures and sorting out technical issues, which if unresolved would lead a company into FRRP-type territory. This was where quality was important. There were considerable quality improvements that companies obtained from their auditors that the outside world did not see. The Audit Committees saw most of this in the papers provided to them. The public saw a clean audit opinion and might think that there were no issues, but the audit process leading to that result was complex.
97. The AEP said that it was important to recognize that, because the parent company had a [X] per cent shareholding in the company, the parent company consolidated the results of the company within its own listed-company financial statements. This placed an additional onus in terms of the auditor's reporting responsibility through to that particular shareholder, because the auditors of the parent company needed the appropriate level of comfort within the signing off of that set of accounts from the company's auditor.

Appointment of the auditor

98. The current auditor was involved in the business prior to appointment. It had been working alongside the previous auditor on some of the issues. Accordingly, it did not approach the company to undertake the audit. The AEP thought that his firm had maintained its relationship with the Boards in a more effective way than the previous auditor. The AEP recognized that this may be because the previous auditor's issue was with the directors of the parent company. The current auditor's overseas firm (as the parent company's auditors) had a very good relationship with those directors.
99. Taking on the audit was a concern. The current auditor could have refused to accept the company audit although this would have put the firm's relationship with the parent company at risk. The current auditor went through a process of deciding whether to accept or not in doing this. The changes to the management and the control environment gave the UK firm the assurance it needed to take on the job. It was also concerned to maintain its relationship with the parent.
100. The reputation of a client was important. The current auditor considered the activities the company was involved in, the quality of the people running the business ie 'can you trust them and can you do business with them?' The AEP noted that in other situations the current auditor had been asked to tender for audits but declined on these grounds.

Annual reappointment

101. The current auditor's performance for the 2011 audit had been reviewed. This was via a questionnaire that was sent to management of different parts of the group. The overall results (scoring basis) were shared with the current auditor. There were areas for the current auditor to improve in the 2012 audit.
102. The ACC and AEP had a conversation in September 2011 about the structure of the audit team. The ACC, reflecting on his recent auditing experience, suggested that the AEP needed a supporting partner at Group level. The AEP did not think this was necessary as he had a Director working closely with him. The AEP also noted that he was working only on one FTSE 100 listed client and so had time to focus on this engagement. Having had the discussion, the AEP had spoken to the CFO who was happy with the current structure and so no changes were made for the 2011 audit. However, as part of the feedback process for 2011 a similar discussion was again held, and [§]. To address these issues in the 2012 audit, the auditor was going to change personnel and would bring in another partner who would oversee this area and provide support at the Group level. There had been no discussion to date around whether this would cost the company more. There were some economies of scope as the new partner was in part replacing another partner. The AEP would reflect on this when negotiating the 2012 fee.

Fees

103. The CFO had management responsibility for fee negotiation and the AEP negotiated with him. There was a more detailed discussion between the Group Controller and the audit firms' Director regarding the fees for the individual entities within the company. The parent company had a say via its Board position and as the overall consolidation of the accounts affected the parent company and had a bearing on the fee.

104. In agreeing the first year fee, the current auditor agreed to some cost savings with the company in relation to the consolidation process, as using just one audit firm removed some duplication of effort. The current auditor agreed to a 10 per cent reduction on the company's audit fee based on the previous auditor's scope. Where additional scope was required the fee would increase.
105. The AEP said that the first year's fee had been set largely on a top-down basis using the previous auditor's scope and fee as a basis. Adjustments had been needed where additional work was required either through additional scope (see paragraph 107) or where additional work was required within the agreed scope.
106. For example, in the UK [§]. The auditors therefore needed to undertake more work to ensure that they were comfortable with the year-end position. The company recognized this and that there would be a negotiation over the cost of this additional time spent by the auditors based on the number of hours, the seniority of the staff involved and the charge out rates.
107. In comparing the fee earned for the audit initially scoped and the fee for additional work, the AEP said that he looked at the overall recovery rate and did not consider these separately. In the first year the recovery rate had been poor but this was not unusual in the first year of a large and complex audit. This work needed to be done and was an investment cost for the current auditor.

Scope

108. The scope was initially influenced by the previous auditor's audit with some additional territories covered and areas to be covered in detail. As the year progressed it became apparent that the scope set by the previous auditor in the USA was less than a full scope audit and the AEP thought that neither the company nor the current auditor had appreciated this until it started fieldwork. The current auditor needed to do this work and the company accepted this. There was a subsequent fee discussion (see paragraph 104).
109. For 2012, there would be a debate as to which entities needed to be covered by a full scope audit. There were around 250 to 300 operating businesses in the group and 40 to 50 of these represented around 85 per cent of the group. The remainder could individually be 100 per cent wrong and this would not affect the accounts materially. The ACC asked questions around scope. He looked to management for comfort and to the company's internal compliance function to look at the areas that were outside the scope of the audit. In some cases, the ACC asked the auditors to cover some of these areas to provide an external view.
110. The AEP said that it was relatively common for companies to ask auditors to do additional pieces of work. This depended on their own internal control structure. He said that for a business such as the company, if they properly followed the COSO framework, improved their control environment substantially, and had their own internal rotational visits that were working effectively; they might at some point decide they no longer needed the current auditor to provide this additional assurance.
111. The fee and audit scope was presented so that it was split such that there was the part relating to the scope needed to obtain a view of whether the accounts were true and fair and the part that was providing extra assurance to management and the Audit Committee.

Quality

112. In describing the measures of quality that the AEP considered when delivering the work, the AEP listed the following:
- (a) quality in the level of work that had been undertaken (ie the scope of work);
 - (b) the quality of the documented audit work providing the basis for the opinion;
 - (c) the quality of the written and oral deliverables provided to management and the Audit Committee; and
 - (d) the quality and experience of the individuals delivering the audit.

Non-audit services

113. Any non-audit services provided by the current auditor were reported to the Audit Committee. The company had a formalized approval process for this which was tiered by value and authority ie CFO up to £100,000, the ACC up to £250,000, whole Audit Committee over £250,000.
114. In 2011, the current auditor provided tax advisory work around the world, due diligence services on potential acquisitions (that largely did not happen), internal controls work and IT strategy. The current auditor was not implementing controls anywhere. The Audit Committee was happy with the provision of internal control work as this was an area that the current auditor needed to understand to do the audit.

The former AEP's view

115. The former AEP [X] was the AEP for the company's [X date] audits. He joined [X], in 1982. He currently audited one FTSE Company [X].
116. The previous auditor was appointed as auditor to the company in [X date] following a tender process. This was commissioned by the Audit Committee, which comprised four NEDs. Both the parent company's auditor and the previous auditor made a presentation to these four independent directors. There was some debate on whether the previous auditor or the auditors of the parent company should be appointed. The conclusion resulted in a compromise. The company's Audit Committee selected the previous auditor as auditors of the former [X] business and the company consolidation. The former [X] business of the parent company in the UK, Germany, Belgium Holland and France as well as the Scandinavian operations continued to be audited by the parent company's auditors. In [X date], the previous auditor took over the full audit of the Scandinavian business and the audit of the full UK business. This appointment occurred shortly before the year-end (in August for a [X date] year-end) and so the previous auditor had undertaken its usual interim procedures later than would otherwise have been the case in relation to the newly transferred audits in Scandinavia and the UK, prior to the [X date] audit.
117. The previous auditors raised a series of issues in relation to the lack of reconciliations for certain balances in the UK business. The previous auditor accepted management assurances—on the basis that high level logic checks (proof in total) were performed by management had been reviewed by the previous auditor and had in previous years been reviewed by the parent company auditor who had been satisfied that there was no significant issue and the previous auditors had discussed this with the parent company auditor—that this would not affect the

company materially, but made clear a full reconciliation was expected for the following year's audit.

118. As part of the previous auditor's review of interim reporting in [X date], it raised the lack of reconciliations again, and asked the company to perform a reconciliation. Following an internal review, a shortfall was discovered in the accounts. The previous auditor and the company then started work on a full-scale reconciliation. There was an expectation that the Board would want assurances that the issue had been resolved before the release of the next financial statements. The previous auditor was kept involved as it was clear there could be a material effect on the year-end accounts. In [X date], (following discussion with the parent company and Audit Committee) an announcement was made to the stock market. At this stage the company and the previous auditor were still investigating the extent of the shortfall, and the previous auditor made it clear to the Audit Committee that this was the case. The shortfall was due to two of the computer systems not matching data correctly [X].
119. The review of the unreconciled balances led to a further £[X] million restatement (due to a result of failures to reconcile balances adequately in legacy systems in the [X]). The former AEP said that the gross adjustment arose as a result of a failure to reconcile ledgers and that the error had built up over an extended period [X date]. The company's own analysis suggested that a very significant element of this had built up [X].
120. The previous auditor signed off the [X date] accounts as it was satisfied with the evidence as well as confident that the former CFO and his team had integrity and openness with the auditors [X]. However, due to a breakdown of relations between the previous auditor and certain directors at the company it made an internal decision not to seek reappointment. [X]
121. [X] the previous auditor signed the true and fair opinion and then resigned. [X] According to the former AEP, the parent company auditor was then appointed at the parent company's behest and this had always been its desire.
122. There was no discussion between previous auditor and the non-parent company shareholders during this time. The former AEP was not aware of whether it had been raised between the SID and the non-parent company shareholders at any stage.

Subsequent relations between the previous auditor and the company

123. [X] The previous auditor continued to provide non-audit services to the company. The previous auditor's knowledge and understanding of the industry and its ability to provide insights had led it to win some consulting work at the company. The previous auditor was also being engaged in some work to address the systems issues that had been identified through its audit.

The former AEP's reflections

124. [X] The former AEP said that auditors did have an eye on companies' share prices when completing their work: they were conscious of the shareholders interests. At the same time they had to balance this with the need for good governance. [X]
125. The former AEP said that the experience of the involvement of multiple audit firms demonstrated, in his view, the need to ensure that matters discussed at a divisional level between the management team and the local auditor should also be flagged to

the group management and the group auditor. The former AEP said that this was evidence against a joint or modular audit for a group of this nature. He had no doubt that with one firm conducting the audit there would be better dialogue between group and divisional auditors.