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Dear Ms O'Sullivan

Consultation on audit firms providing non-audit services to listed companies that they audit

Independent Audit Limited is a corporate governance advisory firm. We do not undertake financial statement audits and are not ourselves affected by restrictions on non-audit services. Some of our partners were formerly external auditors and our work with listed company clients gives us insight into their relationships with their auditors. Our comments on the consultation paper therefore come from the point of view of informed observers with no interests at stake.

The consultation paper provides an excellent survey of the arguments and evidence around the provision of non-audit services by auditors. Our comments are set out in this letter; unless the context requires otherwise, when we refer to non-audit services we mean such services provided by audit firms to the companies they audit.

Summary

We have observed that audit committees and audit firms have in recent years become sensitive to the issue of non-audit fees and take their compliance with relevant standards very seriously.

We believe, and the evidence summarised in the consultation paper appears to show, that the issue under debate is primarily one of perception, but we consider that it is no less an issue for that. However, we do not think that substantive regulatory change is needed since shareholders are able to put pressure on audit committees to restrict the extent of non-audit services and there is no evidence that they need protection beyond what they are capable of making for themselves.

If this argument were to be found insufficient to meet the public demands on the matter, then we think it would be better to make changes to address perceptions and increase confidence in the objectivity of audit by means other than introducing significant new restrictions on non-audit services. And we do not think that the public interest objective of increasing competition in the large company audit market would be greatly, if at all, served by any such restrictions.

The nature of the question

The academic evidence that is helpfully summarised in the consultation document is entirely consistent with the widespread anecdotal evidence that:

- a) Non-audit fees have little or no detrimental effect on an auditor's objectivity and thus on the quality and integrity of the audit, except occasionally in isolated cases.
- b) However, the perception that there is such an adverse consequence is widespread amongst at least some institutional shareholders and investor bodies, as well as other influential groups such as politicians and the press.

Our own professional experience, formerly as auditors and currently as advisors to listed companies, leads us to the view that the Ethical Standards and the Audit Quality Framework are between them sufficient to address (to a reasonable and realistic level) the real risks to audit objectivity arising from non-audit services, and that the Audit Inspection Unit is a sufficient enforcement mechanism.

However, this is unfortunately not enough to dispose of the matter. If the purpose of audit is to increase shareholder (possibly stakeholder) confidence in corporate reports, then the perception of a weaknesses in audit is significant irrespective of whether the underlying facts support the perception. Consequently, it is not sufficient to dismiss shareholders' and others' concerns on the grounds that they are unfounded.

In our view, the issue raises three questions that need to be answered:

- 1 Is the existence of this (mis)perception something that regulation should address?
- 2 If so, how?
- 3 Are there any other public policy reasons to take into account when considering answers to the first two questions?

We consider each of these questions below.

1 Should regulation seek to rectify this perception?

We see no reason in principle why this should be a matter for regulation. Shareholders, who are the principal "victims" of any supposedly adverse consequences of non-audit services, are not helplessly dependent upon regulation for their salvation. They already have various powers by which they can demonstrate their displeasure with the level of non-audit services provided by auditors: to vote against the annual reappointment of an auditor; to vote against the adoption of the accounts; to vote against the re-election of the members of the audit committee. The threat, and occasional exercise, of these powers has contributed substantially to the reduction in non-audit fee levels described in the consultation paper.

These threats primarily bear on audit committees rather than on auditors, but audit committees now have a formal role in monitoring and approving non-audit services. In our experience they are generally attentive to their responsibilities in this regard and sensitive to the possibility of an adverse reaction from shareholders.

Consequently, in our view regulation need go no further than ensuring adequate disclosure of non-audit services so that shareholders are able to monitor the situation and put pressure on audit committees to regulate the level of non-audit services.

The present disclosure regime is broadly adequate but it might usefully be extended by requiring audit committees to explain in their annual reports why the auditors were the most suitable provider of significant non-audit services, and what safeguards were established against any resultant threats to objectivity. This does of course presume meaningful rather than boiler-plate explanations.

Such safeguards would normally be those envisaged in the Ethical Standards but there may be occasions when more is needed, possibly including independent assurance – for example, the audit committee of a company that was incurring a high level of non-audit fees recently commissioned an independent review of the way in which non-audit work was commissioned and managed, and whether the audit committee had acted reasonably, in order to provide additional comfort to both audit committee and shareholders.

Having said all this, we acknowledge that the current level of public and media interest in non-audit services might mean that these arguments, no matter how well-founded they might be, are insufficient to resist the political pressure for additional regulation of non-audit fees. Should that prove to be the case, then the next question is:

2 How should regulation best seek to address the perception that non-audit fees impair audit objectivity?

The most obvious answer to this question would be to reduce the range and value of non-audit services that auditors may provide. However, as is so often the case in real life, the issues are more complex than is often made out and the most obvious answer is not the best one. The arguments in favour of allowing non-audit services, while perhaps not as overwhelming as their proponents might like, do have merit; whereas the arguments against have little merit apart from their effect on perception.

We therefore think that regulation should seek to address the perception of impaired objectivity so far as possible by means other than wider restrictions of non-audit services. Such means might include any or all of, for example:

- Requiring annual pre-approval by shareholders of a limit on non-audit fees payable to the auditors, the limit to be proposed by management with the approval of the audit committee and the resolution put forward for approval being accompanied by an explanation of why it would be in shareholders' interests to approve it.
- Requiring annual pre-approval by shareholders of any arrangement for the continuing supply of non-audit services by the auditors (for example the provision of internal audit services).
- Improved reporting by audit committees, sufficient to provide evidence of the quality of their oversight, and specifically including enhanced reporting of how committees review their own effectiveness and that of the external audit.
- A non-audit fees threshold which would serve as a trigger for an early and rigorous review by the Audit Inspection Unit.

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- An explicit requirement for audit firms' boards, or other governance structures responsible for overseeing public interest matters, to review large public company audit clients which had, or were expected to have, material non-audit fees, in order to be satisfied that threats to objectivity were mitigated, and to describe each such case in the firm's transparency report.

We also note that the proposed UK Code on Corporate Governance and the Walker Review both require periodic external review of board effectiveness. Confidence in audit committees and in their oversight of audit would be increased if they were encouraged or required to have, and report upon, periodic reviews of their effectiveness by independent experts, rather than their effectiveness review being wrapped up in a more general review of board effectiveness which might not address the specific, sometimes very technical, aspects of an audit committee's work.

3 Are there any other public policy reasons to take into account when considering answers to the first two questions?

In our view the only relevant additional public policy question relates to competition. While it would certainly be desirable to have more than four players in the large company audit market, we think it unlikely that restricting non-audit services by auditors would contribute significantly to this happy outcome.

Over the last few years, medium-sized firms have been increasing their penetration in the non-audit market amongst large listed companies. From our understanding of the dynamics of this market and the audit market, we see little reason to suppose that further restrictions on non-audit services would lead to this work going disproportionately to medium-sized firms rather than to other Big Four firms, at least not to the extent that it would materially alter the market. And we see even less reason to think that prominence in the non-audit market, were it to be achieved through regulatory intervention, would lead to a breakthrough in the audit market.

Measured, rather than forced, growth is likely to achieve the best results for medium-sized firms in terms of them developing the reputations amongst large corporate buyers that might eventually lead to them being widely viewed as real candidates for audit appointments. The one regulatory intervention that might be helpful in this context is requiring companies to disclose the names of their various providers of non-audit services, in order to build up shareholders' familiarity with names other than the Big Four and increase their confidence in other firms as potential providers of audit services.

The appendix to this letter sets out brief responses to the specific questions posed in the consultation paper.

Yours sincerely



Jonathan Hayward

Appendix – responses to specific questions

1 (a) Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?

Discussion with shareholders shows that the answer to this question is yes. It is also commonly presumed by the press that a high level of non-audit fees is a sign of impaired independence.

1 (b) Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality?

We are not aware of any instances where non-audit services was clearly the prime cause of shortcomings in audit quality. We have occasionally observed cases where the auditor was too closely aligned to the client and this would sometimes lead to a high level of non-audit fees. To this extent, non-audit fees could be a symptom, if not the cause, of impaired audit objectivity, but it is an indicator which is very unreliable and has too high a rate of both false positives and false negatives to be of real use.

In our experience there are many more occasions when a high level of non-audit fees co-exists with a high quality and objective audit. It is also entirely possible for low levels of non-audit fees to sit alongside a poor quality audit.

We have also encountered at least one audit of a large company where the almost complete prohibition of non-audit services imposed by the audit committee had a negative effect. It seemed to have led to the audit becoming excessively routine, with insufficient interest and engagement by the audit team.

2 If you do consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors please identify which non-audit services are of concern.

It appears to us that, in the main, shareholders' concerns are generalised on the level of non-audit fees rather than focussed on specific services, although it is usually possible to get them to express concern about specific services by asking leading questions.

3 In the light of your answers to questions 1 and 2, do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit?

We think it unlikely that tweaking what is allowed and what is forbidden will make a significant difference, since many shareholders and most other commentators seem to focus on the total level of non-audit fees and do not differentiate between types of service. We suggest in the main body of this letter that further work by the APB should instead seek to increase shareholder confidence in the objectivity of audit by, for example, requiring additional reporting by audit committees regarding the effectiveness of their oversight of auditors, and ensuring that shareholders are well-positioned to monitor non-audit services and put pressure on audit committees where necessary.

Appendix (continued)

4 If you think that there should be a change in the current arrangements, [what] would you advocate?

Please refer to the main body of this letter.

5 In setting the standards relating to auditor independence, do you believe regard should be had to the perceived benefits that are derived by companies from the provision of non-audit services by their auditors?

There is more evidence, albeit largely anecdotal, for the benefits of non-audit services than for the dangers. Consequently we think that the APB should seek ways of increasing confidence in the objectivity of audit that do not involve more extensive restrictions. Only if such ways are impractical or insufficient should further restrictions be considered.