



Date: 7 August 2008

Submitted by email to:
FAO: Chris Hodge
Email: auditorchoice@frc.org.uk / c.hodge@frc.org.uk

16 Park Crescent
London W1B 1AH

Tel: 020-7612 7039
Fax: 020-7612 7034

Email:
cwright@icsa.co.uk

Dear Chris

FRC - Choice in the UK Audit Market Progress report and further consultation

The issue of auditor choice affects many of our members, especially those working in medium to large PLCs and, as a result, the above report and consultation are of particular interest.

The general consensus of members is that there should be greater choice than just the “Big Four” audit firms to audit larger international organisations. The difficulties of audit firms outside this group to enter the market are recognised. It has been suggested that the relaxation of certain rules and the offer of incentives should exist to enable smaller audit firms to offer audit services to larger companies so as to provide a greater field of choice. However, such assistance does have implications which need to be communicated and considered. Any amendments to systems to aid greater choice should not lead to a reduction in the quality, rigour and standards of firms which wish to operate in that arena. It has been commented that if bigger audit firms had not so aggressively combined in the past, there would be more “supply” side choice in the market place and the corollary of that is the “demand” side becomes a difficult concept in what is almost a cartel situation.

Our response to the consultation document is set out below:

A. A brief description of the steps carried out to contribute to the objectives of the MPG’s recommendations (see appendix 1 of the consultation for progress on MPG recommendations).

MPG Recommendations:	Explanation/ Commentary
The increased choice for public interest entities would require both an increase on the “supply” and “demand” sides i.e. the propensity of non-Big Four firms to offer audit services and for public interest entities to select them. To aid the supply side greater investment would be required and key developments making this feasible included: <ul style="list-style-type: none">• A relaxation of ownership restrictions in the audit profession would help reduce market concentration as	<i>The proposals here to assist the supply and demand sides appear to be reasonable.</i> <i>Reducing restrictions to entry will be welcomed by many and would appear to outweigh claimed risks of possible abuse by the existing Big Four companies, in terms of them also taking advantage of the</i>

<p>suggested by an EU independent study.</p> <ul style="list-style-type: none"> • A guide by a working group formed by the Consultative Committee of Accountancy Bodies on the voluntary disclosure of the financial results of work on statutory audits to help potential new entrants to assess the viability of the supply services. • With effect from 6 April 2008, the ability of auditors to negotiate with clients a limitation liability agreement under Ss. 534-538 Companies Act 2006 (CA06). <p>To aid the demand side the primary responsibility for selecting auditors should remain with public interest entities' boards, however risks to directors would need to be reduced and accountability to shareholders increased. Key developments reducing this risk include:</p> <ul style="list-style-type: none"> • New audit regulations and guidance by the Joint Audit Committee of ICAEW, ICAI and ICAS for mechanisms allowing access by incoming auditors to relevant information held by the outgoing auditor would reduce risk and cost of changing auditors. • The FRC Framework for Audit Quality to help improve the communication and assessment of the capabilities of different audit firms. • The proposed guidance within this consultation of using forms from more than one network for individual components of the audit process. <p>Key developments improving accountability of boards for their audit selection include:</p> <ul style="list-style-type: none"> • The Corporate Governance Policy and Voting Guidelines relating to auditor selection by investee companies by the National Association of Pension Funds (NAPF) builds upon statements on auditor selection made by the Association of British Insurers (ABI) and six investment organisations in 2006. • Proposed changes to the Guidance for Audit Committees (the Smith Guidance) by FRC includes explanations to shareholders as to how the decision was made to appoint, re-appoint and remove the external auditors including contractual obligations requiring certain types of audit forms to be appointed. 	<p><i>relaxed rules to aid greater investment themselves. The perceived advantage to smaller audit firms of limiting liability will remain to be seen, but at least the CA06 provides a mechanism to allow this, which was previously prohibited.</i></p> <p><i>With regard to the demand side, greater access to information to incoming auditors and the assessment of the capabilities of different audit firms would hopefully assist boards. The proposal to allow the use of more than one network of auditors to audit individual components of a group, to achieve audit quality for each component and the group as a whole, is a compelling one. This could allow expanding companies alternative approaches to using the Big Four firms.</i></p> <p><i>It is acknowledged that the responsibility for auditor choice should remain with boards, however director risk does need to be safeguarded while decision making needs to be transparent. The proposals appear reasonable. ICSA's response to the Consultation on the proposed changes to the Smith Guidance was generally in favour subject to a few minor concerns.</i></p>
<p>As the above recommendation could take many years to contribute to a meaningful increase in the choice of auditors, the MPG also considered how to increase the potential for switching between the Big Four firms for the very largest public entities and the key development is:</p> <ul style="list-style-type: none"> • Proposed changes to the Smith Guidance (referred to above) to achieve greater consistency with the relevant ethical standards of auditors by offering more support to audit committees in assessing the independence and objectivity of their external auditor. 	<p><i>ICSA has previously responded to these proposals as being reasonable amendments, bringing all guidance and standards into line to avoid confusion over interpretation.</i></p>
<p>The key development for reducing the risk of one of the Big Four leaving the market without good reason is:</p>	

<ul style="list-style-type: none"> The ICAEW has formed a working group, chaired by Norman Murray that will develop a code of best practice governance for accountancy firms that audit public interest entities. 	
<p>The MPG also considered actions which market participants could take to reduce the uncertainty and disruption costs resulting from a firm leaving the market:</p> <ul style="list-style-type: none"> Changes in the Smith Guidance that audit committees assess periodically the risks associated with the possible withdrawal of their external auditor from the market and any whether mitigating action is appropriate. 	<p><i>ICSA has previously responded to these proposals as being a reasonable assessment for any audit committee to consider periodically and how such an event would impact upon their company.</i></p>
<p><i>Other developments:</i></p> <p>In the US, provisional recommendations designed to increase investor protection and enhance the sustainability of a strong and vibrant public company auditing profession is being developed.¹ As well as promoting the growth of smaller auditing, the Committee has also considered:</p> <ul style="list-style-type: none"> Disclosures by public companies of provisions in material agreements which seek to limit auditor choice. The development and disclosure by firms of key indicators of auditor quality. Shareholder ratification of auditor selection by public companies. A mechanism to assist the preservation and rehabilitation of a troubled larger auditing firm. The representation of smaller auditing firms in committees, forums, fellowships and other engagements. <p>The Committee is expected to complete its work in July 2008.</p>	<p><i>Similar measures as are being mooted the US are welcomed, provided they are not overly prescriptive or legislated for, resulting in inconsistencies and conflict with UK/ European guidance/ procedures.</i></p>

Qu.3 - Comments on the other aspects of progress with the implementation of the MPG's recommendations (A and appendix 1).

Comment: In general we support/ agree with the progress and recommendations as per comments above. We have no additional comments on other aspects.

B. An overview of the discussion on the possible effects on audit choice of changes to audit firm ownership rules.

Consultation analysis	<i>Explanation / Commentary</i>
<p>“Changes to the ownership rules could make it easier for existing or new non-Big Four firms to make step-change investments...”</p> <ul style="list-style-type: none"> One barrier to entering the FTSE 100/250 audit arena was the need for substantial resources and expertise to attract large, complex, international companies. The ability to raise substantial equity finance is limited by CA and EU law requires audit firms to be controlled by qualified auditors. The cost of both equity and debt capital for publicly traded auditors could be lower than for partnerships, thus, changing 	<p><i>Suggested changes could possibly be advantageous in the long-term but would need to be made in conjunction with other changes.</i></p>

¹ By the Department of the Treasury appointed Advisory Committee on the Auditing Profession.

<p>the rules to allow alternative debt structures combining the advantages of partnerships and similar structures with lower cost capital of outside and diversified investors.</p> <ul style="list-style-type: none"> • Debt finance is easier, cheaper and less costly to access and manage. However non-Big Four audit firms could face greater challenges than the Big Four in raising finance through bond issues, particularly large-scale, long-term investment investments in excess of the firm's tangible assets. 	
<p>"...although any changes need to be considered as part of a package of measures to improve audit choice"</p> <ul style="list-style-type: none"> • Non-Big Four firms would only invest to supply large company audits if the risks were acceptable and there was a real prospect of being selected. • A package of recommendations, including changes to ownership rules alongside other changes, would assist in the medium term to increase market choice to all but the largest public entities. In the long-term this would provide a platform for non-Big Four audit firms to expand into the provision of audit services for the largest companies. 	<p><i>Agreed. It is unlikely that there is one stand alone change that would achieve the majority of desired outcomes.</i></p>
<p>"The risk that changes to the ownership rules could lead to <i>increased</i> concentration in the market could be outweighed by the potential benefits"</p> <ul style="list-style-type: none"> • There are concerns that the Big Four firms could use the changes to raise substantial external capital for investment might make barriers to entry for other firms even higher. • It is generally accepted that regulators will monitor the behaviour of dominant players against competition law, rather than increasing regulatory limits on investment. • Even if the Big Four were to raise external capital, this would not preclude substantial fund raising by other firms. High risk/ reward investors would invest in growing firms and conservative investors in more established firms. 	<p><i>It is acknowledged that the Big Four firms can already raise sizeable sums under current rules but generally choose not to do so; plus, as stated opposite, this does not preclude fund raising by other firms. Investors will be guided by their risk/ reward preferences, so the perceived threat is probably minimal.</i></p>
<p>"There is a risk that financial considerations associated with outside ownership could drive down auditor quality but safeguards already exist"</p> <ul style="list-style-type: none"> • Focus on short-term profitability and equity value could lead to lower audit quality and a less effective audit process. • Risks to auditor independence and audit quality already exist. Risks are mitigated through regulation of who is permitted to carry out statutory audits and conduct audit work including training, examinations, ethical standards and guidance, disciplinary arrangements, disclosure of non-audit fees to name a few. • Concerns that outside ownership would lead to lower audit quality assumes that owners are unaware that the value of their investment could be damaged or destroyed if the firm loses its reputation for quality and independence. 	<p><i>Although there might be a risk, the safeguards already in existence are likely to outweigh the risks. Plus, as stated in the consultation analysis, firms with external ownership are likely to have a stronger framework of effective accountability for their actions in order to achieve high quality work than partnerships, in order to protect their investment.</i></p>
<p>"There is a risk that outside ownership could lead to a shortage of</p>	

<p>partners and staff with appropriate skills and personal qualities but this could be mitigated with appropriate policies”</p> <ul style="list-style-type: none"> • Culture and rewards of the firm could become less attractive resulting in a shortage of partners and staff with appropriate skills and qualities. Knowledge and experience could also diminish through partners selling out and retiring early. • Equity takes often support below partner level retention and using equity could attract and retain individuals at partner level who might not otherwise see a long-term career path with the firm. • The culture of audit firms, which is centred on the role of partners, might not change. The responsibility for a senior statutory auditor to sign audit reports on behalf of the firm would remain. • The firm could make standard “lock-in” arrangements by issuing tradable stock to existing partners, thus mitigating risk of untimely loss of senior staff. 	<p><i>It would appear that appropriate mitigating policies would outweigh the risks.</i></p>
<p>“Existing company law, regulations and market practice could prevent possible conflicts of interest associated with the firm’s ownership resulting in poorer quality audits”</p> <ul style="list-style-type: none"> • Conflicts of interest, issues of independence and misuse of sensitive information, could arise during an audit due to relationships with owners of the firm and the company relating to financial dependence or potential employment. Such factors could impact on audit quality. • There are some concerns that owners might be poorly informed or uncommitted to the drivers of audit quality and induce a risk taking culture. • The APB’s ethical standards prohibit firms providing audit services to those able to influence the firm, including owners or affiliates of owners. • European Company law (CA06 Sch 10) requires that owners or shareholders do not intervene in the execution of a statutory audit in a way that jeopardises the independence and objectivity of the statutory auditor. • Institutional shareholders and audit committees would consider a firm’s compliance with best practice guidance on corporate governance as set out in the Combined Code and other various audit guides being developed. This might include the board balance, independence, appointment policies, internal controls and remuneration policies. 	<p><i>Similar issues were raised in the recent proposed changes to the Smith Guidance. If guidance and ethical standards are brought in line, it would be hoped that such conflicts would be reduced and that companies’ boards would have the ability to check and assess audit firms’ internal procedures. In addition, various corporate governance guides will assist shareholders, audit committees and boards to monitor and review practices. Some of the risks assume that owners do not appreciate that lack of intervention could devalue their investment, which in reality is probably not the case.</i></p>

Qu.1 - Comments on the discussion of the effects of changes to audit firm ownership rules and also on the completeness and accuracy of the analysis including any additions or clarifications. (B).

Comment: ICSA comments are as per above, it would appear the analysis is relatively complete and accurately raises risks and concerns.

C. A summary of the draft guidance on considerations relevant to the use of firms from more than one network.

Summary	Explanation / Commentary
<p>The following, once finalised would form part of the FRC’s guidance on corporate governance which seeks to support boards and audit committees when implementing relevant provisions of the Combined Code.</p> <p>Under UK auditing standards the group auditor cannot limit its responsibility by referring to the work of another firm. There are key quality drivers that need to be in place for a group auditor’s work to be effective:</p> <ul style="list-style-type: none"> • Well structured, effective and efficient audit methodology. • Arrangements to: <ul style="list-style-type: none"> ○ safeguard auditor integrity, objectivity and independence, ○ ensure partners and staff understand their client’s business and those performing on site audit work have sufficient experience. • Effective, understood, applied quality control procedures and communication between the group auditor and the parent company’s audit committee covering the key risks identified and judgements made in reaching the group audit options. <p>Achieving the above presents significant challenges to the auditor where there are international components, which varies by group but may include:</p> <ul style="list-style-type: none"> • The extent to which: <ul style="list-style-type: none"> ○ the group has international operations and subsidiaries, ○ components of group transact with each other, ○ the finance function is centralised, ○ components require local statutory audits. • Countries and regions in which the group has international components. • Diversity of group’s operations including industry in which it operates. 	<p><i>Any guidance which supports and assists boards, and directors on audit committees, is welcome.</i></p>
<p>The “single network” arrangement is common as it is perceived this will contribute to a high quality and cost-effective audit and will meet the key quality drivers listed above. In assessing the use of firms from a single network, audit committees may wish to consider:</p> <ul style="list-style-type: none"> • Do each of the network’s member firms involved in the group audit have partners and staff that understand the group’s business? • Will each of the network’s member firms select staff with sufficient experience to perform detailed “on-site” audit work? • Will the group auditor review the degree to which the firm has followed the network’s common audit methodology and 	<p><i>These appear to be suitable aspects for any audit committee to consider. The crucial point will be how well the questions are answered and illustrated by the audit firms in question and what the audit committee should do if a satisfactory answer is not forthcoming. Other considerations are that such processes could be time consuming and costly and, once undertaken, what should be done with the results? How much should/ needs</i></p>

<p>associated procedures?</p> <ul style="list-style-type: none"> • What quality checks and inspections are carried out by the network organisation on its member firms? What information is available to the group auditor on the results of these quality inspections and on any follow-up actions? 	<p><i>to be released to shareholder?</i></p>
<p>An alternative approach is to appoint a single firm to audit the parent company and the group’s consolidated financial, but agree that some components of the group audit work and audits for subsidiaries would be carried out by one or more firms from other networks. In assessing the use of “firms from more than one network”, audit committees may wish to consider:</p> <ul style="list-style-type: none"> • How will the group auditor assess the independence and professional competence of firms from other networks? • Will the group auditor be able to understand the methodology of other firms allowing it to evaluate the audit evidence obtained? • How effectively will firms from different networks communicate with each other? • What costs will be attached to the group auditor assessing firms from other networks, evaluating audit evidence obtained by them and addressing any issues? 	<p><i>This format provides flexibility and could provide access to smaller audit firms to offer services to larger companies and expand the available choice. However, with this come additional considerations, checks and balances for company boards. As above, the criteria are reasonable for any audit committee to consider.</i></p>
<p>Another alternative approach the use of “joint auditors” where the group appoints two firms who are expected to reach a single group audit opinion for which they are jointly responsible. Audit work that is needed for group audit purposes would normally be carried out by firms from joint auditors’ networks. Groups may find this arrangement useful if they:</p> <ul style="list-style-type: none"> • Have completed a merger and wish to maintain audit experience and knowledge by keeping auditors involved in ache of the merged entities. • Wish to facilitate the rotation of audit firms by maintaining audit knowledge and experience. • Reduce the scope for close relationships to build up with the auditor or for the auditor to become complacent. <p>In assessing the use of joint auditors, audit committees may wish to consider:</p> <ul style="list-style-type: none"> • How effectively would the two joint auditors coordinate their work and cooperate with each other in reviewing findings? In particular, is there a risk that parts of the company’s accounts could “fall between the gaps” of two firms? • Could management “divide and conquer” the firms i.e. allocate responsibilities to them in a way that directs attention away from areas where audit issues could be highest? • Where there is overlap of effort between the two firms, how costly would this be? 	<p><i>It is envisaged this would be an option for special scenarios (such as those listed) and not as a general alternative approach, owing to the difficulties of two unrelated firms managing to agree a single group audit opinion – which could delay the audit process considerably. However, in certain circumstances this could be a suitable alternative approach and the criteria for audit committees to consider again appear to be appropriate. Although the criteria appear to be appropriate, achieving satisfactory supporting evidence to answer such issues could be difficult.</i></p>

Qu. 2 - Responses to consultation draft guidelines on the use of firms from more than one network in particular:

- i. whether the guidance fairly reflects the circumstances in which groups may find it useful to consider each group audit arrangement (firms from a single network, more than one network or joint auditors; and
- ii. whether the guidance fairly reflects the factors that audit committees may wish to consider for each group audit arrangement. (C).

Comment: General responses to the draft guidelines on the use of firms from more than one network are as set out above. With regard to (i) it is generally believed that the guidance is a fair reflection of the circumstances. In respect of (ii), again the guidance fairly reflects the factors that audit committees may wish to consider for each group audit arrangement.

D. Conclusion and additional comments

Comment: In conclusion, the discussion topics above are comprehensive and in general would be agreed with. The proposed guidance would also appear to be reasonable and any assistance to boards in the execution of their duties is welcomed. However, some may query the resources involved in discharging these duties and also what course of action should boards take if answers and evidence to the assessment questions be inconclusive or unsatisfactory or, if acceptable, how / whether this should be disclosed.

Yours Sincerely



Catherine Wright
Head of Policy, Corporate
ICSA