



**FINANCIAL REPORTING COUNCIL**

**CHOICE IN THE UK AUDIT MARKET**

**PROGRESS REPORT AND FURTHER CONSULTATION**

**MAY 2008**

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## One - Background

Over the last two years the FRC has facilitated a public debate about the risks arising from the characteristics of the market for audit services to public interest entities in the UK. The debate started from a concern that the degree of concentration in the market posed some risks to the capital markets and to the wider aspects of the economy which rely on the availability of audited financial statements.

Informed by an independent study of the market prepared by a firm of economic consultants, the debate evolved to recognise that the primary risk was one of uncertainty and costs in the event of one or more of the Big Four firms leaving the market. There was general agreement that there would be serious difficulties in the market if the number of major firms fell from four to three, especially as it would be neither possible nor desirable to reduce such risk to zero. There was broad agreement that the fundamental issue was one of auditor choice rather than of competition issues such as pricing or quality.

It was generally agreed that the most attractive way to address the issue was to enhance the efficiency of the market, whilst protecting or enhancing audit quality and avoiding unacceptable costs. Stakeholders expressed a clear preference for market-led actions, rather than regulatory interventions. However, there was recognition that the audit market has been subject to extensive regulatory requirements for some years and that enabling actions by professional bodies, regulators or legislators may be needed.

The FRC established a Market Participants Group (MPG), which consisted of investors, companies and audit firms, to advise the FRC on possible actions that market participants could take to mitigate the risks arising from concentration in the market. In October 2007 the MPG published, following public consultation, 15 recommendations intended to allow the market to work more efficiently and, in the medium to long-term, to have a positive impact on audit choice in the UK.

This report describes the steps that have been carried out to contribute to the objectives of the MPG's recommendations since their report was published (Section Two). As part of the implementation of the MPG's recommendations, it also includes a discussion on the possible effects on audit choice of changes to audit firm ownership rules (Section Three) and draft guidance on considerations relevant to the use of firms from more than one network (Section Four).

The FRC has committed to make a public report every six months on progress in implementing the recommendations and will report again in the autumn of 2008.

## Two – Key developments

This section describes the steps that have been carried out since the MPG's report was published that could contribute to the objectives of the MPG's recommendations. Appendix 1 shows details of progress on each of the MPG recommendations.

### *MPG recommendations*

The MPG considered that increased choice for public interest entities would require both an increase in the propensity of non-Big Four firms to offer to audit public interest entities (the “**supply side**”) and an increase in the propensity for public interest entities to select non-Big Four firms as auditors (the “**demand side**”). The effectiveness of actions on the supply side would be enhanced by those on the demand side and vice versa.

On the **supply side** the MPG believed that the most important development would be additional investment by the existing non-Big Four firms or new firms in perceived and actual capabilities to audit public interest entities. It would remain for individual firms to decide whether to invest but changes to the market could make such investment more feasible. Key developments directed at making such investment more feasible include:

- The European Commission has published an independent study that suggested a relaxation of ownership restrictions in the audit profession could help reduce market concentration. Within this paper, the FRC has published for comment a discussion of the possible effects on auditor choice of changes to audit firm ownership rules.
- The Consultative Committee of Accountancy Bodies has formed a working group to develop guidance on the voluntary disclosure of the financial results of work on statutory audits to help potential new entrants and others to assess the viability of the supply of these services.
- Under Sections 534 to 538 of the Companies Act 2006, which came into force on 6 April 2008, auditors are able to negotiate with companies whose accounts they are auditing to limit liability by contract to an amount that is “fair and reasonable in all the circumstances”. The FRC is preparing guidance on the implementation of these new provisions.

On the **demand side** the MPG believed that the primary responsibility for the selection of auditors of public interest entities should remain with their boards. However to help achieve the intended outcomes, the risks to directors of selecting a non-Big Four firm would need to be reduced and boards would need to be more accountable to shareholders for their auditor selection decisions.

Key developments directed at reducing the risks associated with choosing to select a non-Big Four firm include:

- New audit regulations and guidance have been published by the Joint Audit Committee of the ICAEW, ICAI and ICAS for mechanisms to allow access by the incoming auditor to information relevant to the audit held by the outgoing auditor and in so doing reduce the actual or perceived risk and cost of changing auditors.
- Following consultation, the FRC has published and distributed a Framework for Audit Quality to help improve the communication and assessment of the capabilities of different audit firms.
- Within this paper, the FRC has published for consultation draft guidance on considerations relevant to the use of firms from more than one network. This is intended to help audit committees to appoint auditors for individual components of a group based on how best to achieve audit quality for each particular component and for the group as a whole. This could result in growing companies using non-Big Four firms considering alternatives to appointing Big Four auditors when their activities expand geographically.

Key developments directed at improving the accountability of boards for their auditor selection decisions include:

- The National Association of Pension Funds has published revised Corporate Governance Policy and Voting Guidelines for its members which include new guidelines relating to auditor selection by investee companies. This builds on statements on auditor selection made in 2006 by the Association of British Insurers and by a group of six investment management organisations.
- The FRC has published for consultation proposed changes to Guidance for Audit Committees (formerly known as the Smith Guidance) including new guidance that the audit committee report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment and removal of the external auditors, including any contractual obligations to appoint certain types of audit firms.

It could take many years for additional investment by existing or new non-Big Four firms to contribute to a meaningful increase in choice for the very largest public interest entities. The MPG also considered, therefore, how to increase the potential for switching between the Big Four firms. The key development directed at increased choice for the very largest public interest entities is:

- The FRC has published for consultation proposed changes to Guidance for Audit Committees including revisions to the Guidance to achieve greater consistency with the relevant ethical standards for auditors. The guidance would offer more support to audit committees in assessing the independence and objectivity of their external auditor.

Because it could take many years for there to be increased choice of auditors for major public interest entities, the market is likely to be faced for some time with a significant risk of uncertainty and disruption in the event of a major audit firm leaving the market. Although there could be circumstances in which it might be entirely appropriate that a firm should leave the market, it is also possible that firms might leave the market without good reason. The key development aimed at reducing this risk is:

- The ICAEW has established a working group chaired by Norman Murray, Chairman of Cairn Energy PLC, that will develop a code of best practice governance for accountancy firms that audit public interest entities.

Because it would be both impossible and undesirable to eliminate the possibility of a firm leaving the market, the MPG considered how it might be possible to reduce the uncertainty and disruption costs which would result from such an event. Although some of the responsibility for planning for the continuity of audits, or alternatives to audits, rests with regulators and government, there are actions which market participants could take. The key development associated with actions by market participants is:

- The FRC has published for consultation proposed changes to Guidance for Audit Committees including new guidance that audit committees should assess periodically the risks associated with the possible withdrawal of their external auditor from the market and consider whether any mitigating action is appropriate.

### *Other developments*

In the US, The Department of the Treasury appointed Advisory Committee on the Auditing Profession is developing provisional recommendations designed to increase investor protection and enhance the sustainability of a strong and vibrant public company auditing profession. Paul Boyle, Chief Executive of the FRC, and Richard Fleck, Chairman of the Auditing Practices Board, were among those who given evidence before the Committee.

As well as calling for the promotion of the growth of smaller auditing firms consistent with the overall policy goal of promoting audit quality, the Committee has been considering:

- Disclosures by public companies of provisions in material agreements with third parties limiting choice of auditors
- The development of key indicators of audit quality and disclosures by firms of these indicators.
- Shareholder ratification of auditor selection by public companies.

- A mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm.
- The representation of smaller auditing firms in committees, public forums, fellowships, and other engagements.

The Committee is expected to complete its work in July.

### **Three - *Discussion topic: Changes to audit firm ownership rules***

This analysis has been produced in response to a recommendation made by the MPG that advised the FRC on the Choice in the UK Audit Market project. The MPG recommended that: “The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.”

In making this recommendation, the MPG noted that the European Commission (EC) was expected to lead a debate over possible legislative change in this area. The MPG intended that the FRC’s work in response to this recommendation would contribute to that debate. This analysis therefore summarises for comment the arguments that have been raised to date both for and against changes to the ownership rules. The EC is expected to consult on changes to ownership restrictions later this year and it is hoped that this paper and comments on it, which will be published on the FRC’s website, will be helpful in due course to those responding to the EC consultation.

#### *Analysis*

#### **Changes to the ownership rules could make it easier for existing or new non-Big Four firms to make step-change investments...**

- In an independent study for the DTI (now BERR) and FRC in 2006, Oxera found that while operating in the FTSE 100 and FTSE 250 company audit segments could in principle be profitable, the initial expansion in the short term (beyond a small number of clients) is problematic due to significant barriers to entry, which raise the cost of market entry. One such barrier was found to be the need for substantial resources and expertise to attract large, complex, international companies. The ability of existing or new audit firms to raise substantial equity finance for such investment is limited by the Companies Act (and European law) which requires audit firms to be controlled by qualified auditors.
- In a further independent study for the European Commission in 2007, Oxera found that the cost of both equity and debt capital for publicly traded auditors could be lower than for partnerships. Oxera suggested that changing the rules would create the possibility that alternative structures could be designed that combine the advantages of partnerships and similar structures with the lower cost of capital of outside and diversified investors.
- One firm told the FRC in its response to the MPG’s interim report that equity finance is more expensive than debt finance, which is easier and less costly to access and manage. However in its study for the European Commission, Oxera found that non-Big Four audit firms could

face greater challenges than the Big Four in raising finance through bond issues, particularly in funding a large-scale, long-term investment in excess of the firm's tangible assets.

**... although any changes need to be considered as part of a package of measures to improve audit choice**

- Non-Big Four firms would only invest in the supply of audits to large companies if the risks involved were acceptable and there was a real prospect of large companies selecting them as auditors.
- The MPG found no 'silver bullets' that could rapidly increase choice at a proportionate cost whilst maintain audit quality. It considered however that a package of recommendations could have a positive impact on the degree of concentration in the supply of audit services to all but the very largest public interest entities over the medium term. In the longer-term this may provide a platform for non-Big Four firms who successfully respond to the opportunities created to expand into the audit market for the very largest public interest entities. It follows that change to the ownership rules should be considered alongside other changes to the market rather than on a standalone basis. It would, in any case, be several years before legislative changes in this area could take effect within the UK.

**The risk that changes to the ownership rules could lead to *increased* concentration in the market could be outweighed by the potential benefits**

- There are concerns that Big Four firms could use the changes to raise substantial external capital for investment that might make the barriers to entry for other firms even higher. However, the Big Four firms could already raise sizeable amounts under the current rules through both debt and minority external ownership but generally choose not to do so, possibly because they are capable of funding investment from current earnings.
- The prospect of existing market leaders investing further to strengthen their position is no different from any other market, and it is generally accepted that the appropriate regulatory response is to monitor the behaviour of the dominant players against competition law, rather than to put in place regulatory limits on investment.
- Even if Big Four firms were to raise external capital, this would not preclude substantial fund raising by other firms. Investors with a preference for higher risk /reward might invest in a growing firm, whereas more conservative investors might choose to invest in a more established firm.

**There is a risk that financial considerations associated with outside ownership could drive down audit quality but safeguards already exist**

- There are concerns that financial considerations, including a focus on the firm's short-term profitability and equity value, could drive actions and decisions by the firm's leadership, resulting in a culture that is less consistent with achieving audit quality and a less effective audit process. This risk could be accentuated for firms whose share price becomes listed or which use share option schemes.
- Risks to auditor independence and audit quality already exist. Audit firms that are partnerships manage their affairs using revenue and profitability measures alongside other measures, creating incentives to focus on achieving short-term targets. The risks are mitigated through regulation of who is permitted to carry out statutory audits and the conduct of the audit work, including:
  - Auditor training, examinations, practical experience and continuing professional development requirements
  - Technical standards and guidance for audit work
  - Ethical standards and guidance for auditors
  - Quality inspections by professional bodies and the FRC's Audit Inspection Unit
  - Disciplinary arrangements of professional bodies and audit regulators
  - The auditor liability regime
  - The criminal offence of knowingly or recklessly providing a misleading, false or deceptive report
  - The disclosure of non-audit fees.
- The concern that outside owners may drive down audit quality assumes that these owners are unaware that the value of their investment could be damaged or destroyed if the firm loses its reputation for quality and independence. Rather than put pressure on the firm to boost profitability at the expense of quality outside investors are arguably likely to have the incentive to help ensure that the firm is protecting its independence and quality. Firms with external ownership would arguably have a stronger framework of effective accountability for their actions to achieve high quality work than partnerships.

**There is a risk that outside ownership could lead to a shortage of partners and staff with appropriate skills and personal qualities but this could be mitigated with appropriate policies**

- There are concerns that audit partners and staff could find the culture or rewards of the firm less attractive, resulting in a shortage of partners and staff with appropriate skills and

personal qualities. Knowledge and experience of staff could also diminish through partners selling out and retiring early.

- In a May 2007 report on UK professional services, Edison Investment Research suggested that for professionally qualified individuals below the partner level, offering an equity stake could support staff retention. At the partner level, rewarding individuals using equity could help attract and retain talented individuals who may not otherwise see their long-term career path within the firm.
- The culture of audit firms, which is centred on the role of the partners, might not change. There would remain a responsibility for a senior statutory auditor to sign audit reports for and on behalf of the firm.
- If a firm was to issue tradable stock to its existing partners, it could make standard 'lock-in' arrangements that would mitigate the risk of an untimely loss of senior staff.

#### **Existing company law, regulation and market practice could prevent possible conflicts of interest associated with the firm's ownership resulting in poorer quality audits**

- There is a risk that partners or staff may not exhibit professional scepticism or be robust in dealing with issues identified during the audit due to relationships with owners of the firm such as financial dependence or potential employment. As a result actions and decisions relating to audits of linked entities (e.g. owners of the audit firm or entities linked to them) could have a negative impact on audit quality, whether real or in appearance. In addition, the incentives for audit firm owners to misuse sensitive information could be increased due to their other interests.
- There are also concerns that owners could be poorly informed on or uncommitted to the drivers of audit quality and may induce a risk taking culture in which partners and staff might not be robust in dealing with issues identified during the audit.
- 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 (in the UK, Companies Act 2006, Schedule 10, Part 2, paragraph 9.- (3)) 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 firm's compliance with best practice on corporate governance as set out in the Combined Code, or in the best practice corporate governance guidance that is being developed for audit firms. They may consider, for example, board balance and independence, appointments to the Board, internal controls and design of performance related remuneration.

### *Invitation to Comment*

To promote debate, the FRC invites comments on this discussion paper to be published on the FRC's website. Views are sought, in particular, on the completeness and accuracy of the analysis, and any additions or clarifications that could be useful. Details of how to respond are shown in Section Five.

## **Four - Consultation topic: Draft guidance on use of firms from more than one network**

### *Introduction*

This draft guidance has been produced in response to a recommendation made by the Market Participants Group (MPG) that advised the FRC on the Choice in the UK Audit Market project. The MPG recommended that: “The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.”

It is expected that once finalised the document will form part of the FRC’s corporate governance guidance that supports company boards in making suitable arrangements for their audit committees, and assists directors serving on audit committees in carrying out their role. While company boards are not required to follow this Guidance, it is intended to assist boards when implementing the relevant provisions of the Combined Code.

The MPG intended that the guidance would provide audit committees of growing companies using non-Big Four firms relevant factors they may wish to consider when their activities expand geographically beyond the perceived capacity of their existing firm. More generally, it was expected that the guidance could also help audit committees to select auditors for individual components of the group financial statements based on how best to achieve audit quality for that particular component and for the group as a whole.

To assist users to compare different group audit arrangements, the guidance includes a description of considerations relevant to the use of firms from one audit network as well as those relevant to the use of firms from more than one network.

### *Drivers of audit quality for group audits*

Under UK auditing standards, the group auditor has sole responsibility for the audit opinion on the group accounts; the group auditor cannot limit its responsibility by referring to the work of another firm.

For the group auditor’s work to be effective there are key quality drivers that need to be in place, including:

- Well-structured, effective and efficient audit methodology
- Arrangements to safeguard auditor integrity, objectivity and independence
- Arrangements to ensure partners and staff understand their client’s business and staff performing detailed ‘on-site’ audit work have sufficient experience

- Effective, understood and applied quality control procedures
- Effective 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 opinion.

Achieving each of these drivers on a group audit presents a significant challenge to the auditor where there are international components. The extent of this challenge will vary by group depending on factors that may include the:

- Extent to which the group has international operations and subsidiary undertakings
- Countries and regions in which the group has international components
- Extent to which the components of the group transact with each other
- Diversity of the group's operations including the industries in which it operates
- Extent to which the finance function of the group is centralised
- Extent to which components require local statutory audits

#### *Use of firms from a single network*

Most groups choose to appoint one firm to audit the parent group and the consolidated group accounts. This firm then uses other firms from within its international network to carry out audit work on components that is needed for group audit purposes. It is common for the same firms to carry out statutory audits of subsidiaries where these are needed.

The 'single network' arrangement is common because using firms from a single network is generally perceived to contribute to a high quality and cost-effective audit. This is because firms from the same network may have:

- Common audit methodology that is generally seen as well-structured, efficient and effective
- Partners and staff in network firms internationally that understand the group's business and have staff available to perform detailed 'on-site' audit work who have sufficient experience
- Common quality control policies and monitoring arrangements across the network that are effective, understood and applied.

In assessing the use of firms from a single network, audit committees may wish to consider:

- Do each of the network's member firms that will be involved in the group audit have partners and staff that understand the group's business?

- Will each of the network's member firms select a staff with sufficient experience to perform detailed 'on-site' audit work?
- In considering the findings of each of the other firms from within its network, will the group auditor review the degree to which the firm has followed the network's common audit methodology and associated procedures?
- 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?

#### *Use of firms from more than one network*

In some circumstances it may be possible to achieve a high quality and cost-effective audit by using firms from more than one network. The group would still appoint a single firm to audit the parent company and the group's consolidated financial statements. However the group would agree with the group auditor that for some components the audit work that is needed for group audit purposes will be carried out by one or more firms from other networks. Additionally the same firms might be used to carry out audits of the subsidiaries where these are needed.

Groups for which this arrangement may be useful could include:

- Groups that consider their current auditor delivers high quality audits but have growing or new subsidiaries in locations not well served by their current auditor's network
- Groups wishing to give subsidiaries the option of which audit firm to use for local audits
- Groups wishing to have the flexibility to select the firms in each country with the most suitable capabilities to carry out audit work on the relevant subsidiary.

In assessing the use of firms from more than one network, audit committees may wish to consider:

- How will group auditor assess the independence and professional competence of firms from other networks?
- Will the group auditor be able to understand the methodology of the 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?

### *Use of joint auditors*

Joint audits are a special case of the use of firms from more than one audit network. 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 the joint auditors' networks.

Groups may find this arrangement useful if they:

- Have completed a merger and wish to maintain audit experience and knowledge by keeping the auditors involved in each 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.

In assessing the use of joint auditors, audit committees may wish to consider:

- 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 an overlap of effort between the two firms, how costly would this be?

### *Consultation*

The FRC invites comments on this draft guidance. The FRC expects to finalise the guidance using the comments received. Views are sought, in particular, on:

- 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, firms from more than one network and joint auditors).
- Whether the guidance fairly reflects the factors that audit committees may wish to consider for each group audit arrangement.

## Five – How to respond

The FRC would welcome views on any matter raised in this progress report, including:

- Comments on the discussion of the effects of changes to audit firm ownership rules in Section Three. Comments received will be published on the FRC's website.
- Responses to the consultation over the draft guidance on use of firms from more than one network in Section Four. Comments received will be used to help finalise this guidance.
- Comments on the other aspects of progress with the implementation of the MPG's recommendations, which will be used by those responsible for the relevant part of the implementation work.

Please submit any comments by Friday 1 August 2008.

Comments should be sent by e-mail to [auditchoice@frc.org.uk](mailto:auditchoice@frc.org.uk) or by post to:

Chris Hodge  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

Unless otherwise stated, responses will be regarded as being on the public record. Please indicate whether your response should be treated as confidential (standard disclaimers in responses received by e-mail will be disregarded for this purpose).

## Appendix 1 – Progress on MPG recommendations

### Recommendations targeted at audit firms

<i>MPG recommendation and objective</i>	<i>Implementation arrangement</i>	<i>Implementation progress</i>	<i>Expected timing</i>
<p><b>1:</b> The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.</p>	FRC to prepare and consult on discussion paper on the possible effects on audit choice of changes to audit firm ownership rules	Discussion paper included in this Update.	Q2 2008
	FRC to use discussion paper to influence legislative change in the European Union and the US.	Following publication in October 2007 of a study carried out for the European Commission that suggested that a relaxation of ownership restrictions in the audit profession could help reduce market concentration, Charlie McCreevy, European Commissioner for Internal Market and Services, announced in December 2007 an intention to launch a consultation on changes to ownership restrictions.	2008
	Existing or new non-Big Four Firms consider raising substantial equity finance.		2010?
<p><b>2:</b> Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.</p>	Guidance for the voluntary disclosure of financial results of audit work to be prepared.	The CCAB has formed a working group comprised of representatives of auditors of public interest entities to develop this Guidance.	Draft guidance Q3 2008 (was Q2 2008)
	Firms start to report on a voluntary basis using the guidance.		2009
<p><b>3:</b> In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.</p>	FRC to send the recommendation to the working group preparing guidance on auditor liability limitation agreements, the European Commission, the US Treasury and other relevant authorities.	Under Section 534 to 538 of the Companies Act 2006, which come into force on 6 April 2008, auditors will be able to negotiate with companies whose accounts they are auditing to limit liability by contract to an amount that is “fair and reasonable in all the circumstances”.	Ongoing
	Further consideration of policy in European Union and the US.	Charlie McCreevy, European Commissioner for Internal Market and Services, announced in December 2007 an intention to put forward a Recommendation to Member States asking them to limit auditor liability other than in cases involving wilful misconduct by auditors.	2008

<i>MPG recommendation and objective</i>	<i>Implementation arrangement</i>	<i>Implementation progress</i>	<i>Expected timing</i>
	Existing or new non-Big Four firms consider further investment.		2010?
<b>4:</b> Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.	FRC to review policies on membership of their boards and committees.	The new FRC Board that came into being on 1 November 2007 has undertaken to comply with the relevant principles and provisions of the Combined Code. The Code provisions include the need for the nomination committee to evaluate the balance of skills, knowledge and experience on a board when considering the appointment of new directors.	Q2 2008
	FRC to send recommendation to International Auditing and Assurance Standards Board, the International Accounting Standards Board, and member bodies of the Consultative Committee of Accountancy Bodies.	In its Call for Nominations for IFAC Boards and Committees in 2009, issued in February, the International Federation of Accountants has included tables setting out the professional diversity of each of its Boards and Committees, including the IAASB. Nominating organisations are encouraged to consider how their candidates would strengthen the professional diversity of the relevant board or committee.	Ongoing
	Non-Big Four firms demonstrate their involvement in standard setting bodies and committees.		Ongoing
<b>5:</b> The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency by the firms and the FRC of the capabilities of individual audit firms.	The FRC to finalise its paper setting out the drivers of audit quality.	A final version was published in February 2008.	Q1 2008 (was Q4 2007)
	Firms report publicly on their capabilities in line with the drivers of audit quality. The Audit Inspection Unit will monitor and report publicly on firms' capabilities in line with the drivers of audit quality.	In April 2008 the POB published regulations requiring auditors of public interest entities to publish annual transparency reports and setting the minimum requirements such reports must meet. The POB encouraged firms to differentiate themselves, for example by reference to the Audit Quality Framework. The POB will monitor the way in which the firms meet their obligations under the new regulations.	From 2008
<b>6:</b> The auditing profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.	The Joint Audit Committee (JAC) of ICAEW, ICAS and ICAI is in the process of developing guidance for their members to allow successor auditors access to all relevant information held by their predecessor in respect of the last audit report signed by the predecessor.	New audit regulations and guidance have been published by the Joint Audit Committee of the ICAEW, ICAI and ICAS for mechanisms to allow access by the incoming auditor to working papers of the predecessor auditor.	Q2 2008

<i>MPG recommendation and objective</i>	<i>Implementation arrangement</i>	<i>Implementation progress</i>	<i>Expected timing</i>
	Firms start to follow new arrangements. Audit Inspection Unit considers effectiveness of new arrangements.		From Q3 2008
<b>11:</b> Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.	The Auditing Practices Board is reviewing the ethical standards. Whilst the focus is on achieving high standards of auditing, the APB will consider the proportionality of the standards. In so doing it will have regard to the views raised in this debate on particular ethical standards.	The APB published revisions to the ethical standards in April 2008. It reported that during its review of the standards it considered changes to the rotation periods for partners involved in listed company audits, including the possible effects of such a change on audit choice. It concluded that there is insufficient consensus to make a change to the current five year requirement at this time. It plans to explore this issue further later in 2008.	Q2 2008
	FRC to send recommendation to the International Ethics Standards Board for Accountants and the SEC.	Report sent.	October 2007
	Firms compete for audits taking account of any changes to the ethical standards.		From 2009
<b>14:</b> Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.	The ICAEW to form a working group to develop a Combined Code -style best practice corporate governance guide for auditors of public interest entities.	The ICAEW has established a working group chaired by Norman Murray, Chairman of Cairn Energy PLC, that will develop a code of best practice governance for accountancy firms that audit public interest entities	Q4 2008
	Firms consider and follow the new corporate governance guide.		From 2009

## Recommendations targeted at companies

<i>MPG recommendation and objective</i>	<i>Implementation arrangement</i>	<i>Implementation progress</i>	<i>Expected timing</i>
<b>7:</b> The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.	FRC to prepare draft guidance and publish this for comment.	Included in this Update (see Annex A).	Q2 2008 (was Q4 2007)
	FRC to publish and distribute the final guidance.		Q2 2008
	Companies consider guidance.		Q3 2008 onwards
<b>8:</b> The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision.	The FRC will prepare revised guidance for audit committees (the Smith Guidance).	Issued for consultation March 2008.  17% of FTSE 350 companies disclosed the rationale supporting auditor appointment or reappointment in annual reports, according to Grant Thornton research published in January 2008.	Revised guidance Q3 2008.
<b>9:</b> When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms	The FRC will prepare revised guidance for audit committees (the Smith Guidance).	Issued for consultation March 2008.	Revised guidance Q3 2008.
<b>12:</b> The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.	The FRC will prepare revised guidance for audit committees (the Smith Guidance).	Issued for consultation March 2008.	Revised guidance Q3 2008.
<b>15:</b> Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.	The FRC will prepare revised guidance for audit committees (the Smith Guidance).	Issued for consultation March 2008.	Revised guidance Q3 2008.

<i>MPG recommendation and objective</i>	<i>Implementation arrangement</i>	<i>Implementation progress</i>	<i>Expected timing</i>
<p><b>13:</b> Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.</p>	<p>FRC and its operating bodies to review policies on regulatory penalties and publish for discussion outline details of any proposed changes.</p> <p>The FRC will also raise the matter with its regulatory counterparts in other major jurisdictions.</p>		By Q3 2008
	<p>Companies consider their response to any audit firm incident taking account of available information on regulatory penalties.</p>		2009 onwards

## Recommendation targeted at investors

<i>MPG recommendation and objective</i>	<i>Implementation arrangement</i>	<i>Implementation progress</i>	<i>Expected timing</i>
<p><b>10:</b> Investor groups, corporate representatives, firms and the FRC should promote good practices for shareholder engagement on auditor appointment and re-appointments.</p>	<p>Investor groups consider information published by companies through recommendation 8 and firms through recommendation 2, 5 and 14.</p>		Starting 2008
	<p>Investor groups consider need for any revisions to existing guidance on shareholder engagement on auditor selection in light of availability of improved information described above.</p>	<p>The NAPF's Corporate Governance Policy and Voting Guidelines, published in November 2007, encourage companies to consider submitting the audit function to periodic tender and disclose their policy on this matter, including when the audit was last subject to tender. The Guidelines also encourage improved disclosure on the auditor re-selection decision and disclosure of any contractual obligations to appoint audit firms.</p>	Ongoing

## Appendix 2 – Market concentration statistics

Table shows percentages unless otherwise stated

AUDITOR	FTSE 100		FTSE 250		FTSE SMALL CAP / FLEDGLING		AIM	
	FEB 08	NOV 06	FEB 08	NOV 06	FEB 08	NOV 06	FEB 08	NOV 06
NUMBER OF COMPANIES	100	100	250	250	522	542	1390	1132
PRICEWATERHOUSECOOPERS	39	42	29.2	31.2	22.2	23.1	11.1	9.8
KPMG	23	22	19.6	22.7	19.9	19.7	13.4	13.3
DELOITTE	21	18	28.9	24.3	17.2	18.1	9.9	9.6
ERNST & YOUNG	16	17	18.5	18.6	21.3	19.9	9.1	7.2
BDO STOY HAYWARD			2.0	2.0	2.9	3.3	10.5	11.8
GRANT THORNTON			2.0	0.4	8.2	2.6	16.0	13.8
PKF					1.7	1.3	3.7	4.1
BAKER TILLY					1.1	2.2	7.9	8.7
ROBSON RHODES					0.0	5.4	0.0	3.4
OTHERS				0.8	5.2	4.4	18.4	18.3
NON BIG 4 SHARE	0%	0%	4%	3.2%	19.2%	19.2%	56.6%	60.1%

*Based on Hemscott Corporate Advisers Rankings Guide with the agreement of Hemscott, a Morningstar company. The FTSE 100 figures exclude TUI Travel plc, as following the merger of First Choice Holidays and the tourism division of TUI AG, the auditor to the new company had not been confirmed at the time that the February 2008 version of the Guide was being prepared. Figures for the FTSE 100, FTSE 250 and FTSE Small Cap / Fledgling include UK and Channel Island domiciled companies. Figures for AIM include UK domiciled companies.*