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The Secretary,
Market Participants Group,
Financial Reporting Council,
5th Floor Aldwych House,
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Dear Mr Rose,

FRC Discussion Paper – Choice in the UK Audit Market

INTRODUCTION

As an investor, I was glad to see the publication of your Discussion Paper – Promoting Audit Quality and your more recent Interim Report on Choice in the UK Audit Market as these debate some of the issues on the role of auditing and the function of the various stakeholders in the business equation. I hope your final report on UK Audit Quality will clearly identify those stakeholders who can rely on that quality and your final report on the UK Audit Market should explore what some investors call the “*Nuclear option*” of removing the Big Four from the market. I still believe that you have made a significant mistake in exploring these two issues **before first resolving** the audit liability problem following the *Caparo* judgement.

My perspective comes from being a working investor creating and running small businesses and being a passive investor by investing in publicly quoted companies around the world. In both roles, I believe that the owners of business should be responsible for the oversight and development of their venture in trade and in the fact that most investors believe that the accounts of a firm are an essential tool in making business decisions.

I would suggest that the main purpose of the audit in company law should be to serve the needs of investors. It is on that basis that I submit my comments on your discussion paper and answer the provisional recommendations you make. I have no objection to my views being put into the public domain.

OVERVIEW

Many investors believe that the accounts of a firm are a key element for investors to interpret their venture in trade and exercise their governance and stewardship functions. They believe that Auditors need to:-

1. Act clearly and specifically on behalf of and in the interest of shareholders.

2. Protect the company from wrongdoing by their hired hands by providing the owners with independent reliable intelligence on the companies' affairs to aid discussions at members' meetings.

It is clearly wrong that the company directors of quoted companies control the appointment and removal of auditors. The owners should do this through their presence on the firms audit committee. I welcome the moves in the Companies Act 2006 to increase the role of the audit committee and would suggest that it should be best practice for this committee to be present and ready to contribute to discussions at members meetings. The appointment, resignation and removal of auditors must be open to inspection and discussion by the owners at such meetings.

At the heart of the Audit Liability problem is the 1990 House of Lords *Caparo* judgement, which held that:-

1. Auditors do **not** have a duty-of-care to individual shareholders.
2. Auditors are only responsible for their work for the 21-day period up to and including the AGM.
3. The only sanction that shareholders have against *negligent* auditors is to replace them at an AGM.
4. The purpose of **an audit** is to provide only guidance in discussing the stewardship of the company directors at a AGM – it is **not a statement of facts**.
5. It is *unreasonable* to expect negligent auditors to be responsible to those that invest or lend money to a company.

On the one hand, many investors argue that this out-of-date, class obsessed judge-based law has *excessively restricted* the rights of owners. They have suggested that as they vote for the appointment of the auditors at an AGM and those auditors directly report to them, it should be only fair and reasonable that they should be able to rely on the auditors work for making management and investment decisions.

On the other hand, as the auditors legal liability has been considerably reduced by the *Caparo* judgement, it is not surprising and entirely predictable that the Big Four accounting firms are vigorously opposing any extension in liability but all in favour of higher quality of information, which the owners have to pay for, but **cannot** rely on. Audit liability is directly related to audit quality. My suggestion is that you should concentrate on identifying the degree of auditor liability that is fair and reasonable **then** build the systems and processes needed to ensure that you have the audit quality to meet that liability. It is that simple!

Answers to your provisional recommendations

Provisional recommendation 1

The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules subject to there being sufficient safeguards to protect auditor independence and audit quality.

My Answer: I do not agree with your commentary on your provisional recommendation when you infer that it is the inability of the non-Big Four firms to increase their capabilities to provide more competition in the audit market. In any market there will be times when a small number of suppliers "*corner-a-market*" and impose their conditions on the users. It is the role of legislators and regulators to prevent this happening.

I believe that the Market Participant Group (MPG) should have examined the "*Nuclear option*" of removing the over-dominant Big Four from the audit market. While discussing this matter the MPG should: (1) Observe the reasonable requirement that Big Four members in the MPG should be excluded from such discussions. (2) Consider the option of having Audit Only firms. (3) Take

expert academic advice on the business theories involved.

Provisional recommendation 2

Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.

My Answer: Yes – there should in addition be full disclosure of the risks involved in their business and details of how they are managing these.

Provisional recommendation 3

In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.

My Answer: What assurance does a UK audit give following the *Caparo* judgement – when in simple terms it gives none after the firms' AGM? Should the MPG have examined the possible option of removing the audit requirement as it was a “*cornered market*” that gave no meaningful value to that process?

If the owners feel they need an audit, they must have direct involvement in setting the terms and conditions of this process. I echo the view of *Morley Fund Management* that “... *Further limitation of liability provides no incentive to quality and may indeed encourage auditors to cut corners and take risks*”.

Ideally auditors should provide unlimited liability cover to named stakeholders as an expression of their confidence in the quality of their work. In cases where doubt over figures or judgement may exist, the auditor should be required to negotiate and put into public domain any liability limitations.

Provisional recommendation 4

Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms.

My Answer: Yes.

Provisional recommendation 5

The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency of the capabilities of individual audit firms.

My Answer: Yes.

Provisional recommendation 6

The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.

My Answer: Yes.

Provisional recommendation 7

The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.

My Answer: Yes.

Provisional recommendation 8

The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.

My Answer: Yes.

Provisional recommendation 9

When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.

My Answer: I support your view that “*There is only very limited direct communication between companies and investors regarding auditor selection . . .*” I echo the view of the National Association of Pension Funds comment “*Investors interest in this area has, with a few exceptions, been lacking and if anything the tendency is to encourage use of the Big Four. There is a real challenge in changing investors' attitude to auditor risk*”. I welcome the US governments inquiries into the activities of the Big Four and it is for these reasons that I feel that it might be wise for the MPG to at least consider and report back on the “*Nuclear option*” of an audit market without the involvement of the Big Four. As some might consider it would be reckless for our legislators and regulators to not have contingency plans to cover this situation.

Provisional recommendation 10

Investor groups, corporate representatives and the FRC should develop good practices for shareholder engagement on auditor appointment and reappointments and should consider the option of having a shareholder vote on audit committee reports.

My Answer: Yes.

Provisional recommendation 11

Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.

My Answer: Yes.

Provisional recommendation 12

The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.

My Answer: Yes.

Provisional recommendation 13

Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.

My Answer: Yes.

Provisional recommendation 14

Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.

My Answer: Yes.

Provisional recommendation 15

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.

My Answer: Yes.

CONCLUSION

As an investor, I believe that is essential for the owners of a limited liability company to have the option to require an independent audit of the firms accounts prepared by those who run the day-to-day operations of the company. Such an audit report should identify those stakeholders and the extent to which they can rely on the audited information. The latest Companies Act requires the audit committee of major public interest entities to negotiate the terms of engagement of the auditors and it would be sensible to require them to know the concerns of stakeholders and have a fiduciary responsibility to them.

One of the fundamental problems in the UK audit market is that with the House of Lords *Caparo* judgement over restricting the liability of auditors to such a degree that the process has little to no value. The political decision has to be made if the legitimate aspirations for the audit report by investors is to be realised by a change in the law.

A second problem is that we have an audit market dominated by the Big Four who have no intention of giving way on the present unfair audit liability situation. We have a culture within these firms which is unable to accept that auditing your own work is wrong. We now have one firm indicted for selling fraudulent tax shelters which cheated the US Treasury out of at least \$2 billion. In my view, the time has come for the Big Four to be made subservient to the values of our democratically elected nation states before they make nationhood an obsolete concept.

My choices for improving the UK audit market would be for the Big Four to be excluded and a new market with say 20 (absolute minimum 10) audit-only firms involved with no firm being allowed to have more than say 15% of the market. Combine this with a meaningful dialogue between owners and auditors and open discussion of auditing matters at members' meetings. I then believe we would have a chance of getting the investor protection we could be proud of.

It is now time for the FRC, MPG and government to declare their position on the audit liability issue for UK quoted companies. Investors will then be in a better position to judge their own involvement in this market.

I would be glad to expand on any of the points I have raised.

Yours sincerely,

Duncan Alexander