

## **Choice in the UK audit market - consultation**

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(Note: this is a personal response and does not necessarily reflect the views of the companies and other bodies with which I am involved)

### **1. Audit committee experience**

- (a) current – Lloyds TSB Group, chairman (FTSE 100)
- Noble Grossart, chairman (private)
  - Royal Society of Edinburgh, chairman (charitable body)
  - Lloyds TSB No 1 and No 2 Pension Schemes, chairman (no separate audit committee)
- (b) previous – Stagecoach Group (still attend all meetings) (FTSE 250)
- Wood Group (FTSE 250)
  - Dunedin Income Growth Investment Trust

### **2. Interim Report of Market Participants Group**

I am generally supportive of the Group's approach and recommendations. I participated by telephone interview in the first stage of the project and was pleased that the FRC then took the initiative to establish an advisory group that included a broad range of stakeholders.

As an audit committee chairman/member, I had serious concerns about the concentration of "Big Firm" influence before the demise of Arthur Andersen. The reduction to a "Big 4" coincided with the long overdue move to restrict the non-audit services that auditors were permitted to provide to an audit client and this put even more focus on relationships and on the paucity of firms with the necessary resources and reach required by large, complex companies. (In the 2 years prior to my becoming chairman of the Lloyds TSB audit committee, the non-audit fees earned by the auditors were, respectively, 5 and 7 times the audit fees)

### **3. Specific concerns**

Objective A – I do not agree with the group's recommendation in A.2.3 (auditors from more than one network). I support the Oxera study findings on this and believe that it would be a retrograde step to promote the use of firms from more than one network. It is difficult enough for an audit committee to satisfy itself that it is getting a satisfactory level of service and challenge from a single firm (see comments in 4 below) without having to consider whether the co-ordination/co-operation between firms is sufficient to ensure consistent audit quality, challenge, efficiency and value for money. In my view audits that involve more than one firm would run an increased risk of being bureaucratic and process driven with less emphasis on or consideration of principles and judgmental issues.

Objective A – I also strongly disagree with the recommendation in A.2.6 (shareholder engagement on auditor engagement). It is the responsibility of the board of directors of a company (using the audit committee as appropriate) to assess the auditor, the quality of their work, whether value for money is received and whether/when it is appropriate to consider changing to another auditing firm. Institutional shareholders are not resourced to make informed judgments on the audit requirements of individual companies and should not be encouraged to "engage with companies over auditor selection policies and decisions" (page 36 of the interim report). Apart from the inappropriateness, it would become too easy for institutions (and particularly

groups of institutions working together on corporate governance crusades) to use such influence to pressurise boards as part of their wider governance agendas.

#### **4. Personal experience**

From my involvement on audit committees over many years, I have generally found that I am able to develop a good understanding of the skills, experience and quality of the management and staff of internal audit and the way they carry out their work. This is achieved through regular contact with senior internal audit staff, attending and participating in their conferences and receiving business risk presentations from them at audit committee meetings. Where there is a separate internal risk function, I have been able to develop a similar level of understanding.

This has contrasted with my experience of external audit where the contact I have had over the years has been generally quite restricted and my understanding of how firms approach and deliver the audit has also been limited. There is little opportunity for an audit committee to form a view of the quality in depth of the audit team or the way they set their priorities and carry out their work. Typically, only one partner will speak at audit committee meetings and the contribution tends to be reactive rather than proactive in discussion. My experience is that external auditors view their principal relationship and contact as still being with a company's executives (and particularly the finance director) and I do not feel that, culturally, auditors have yet adjusted sufficiently to the need to ensure that the audit committee, and particularly its chairman, is sufficiently and timeously engaged in the major issues of accounting policy and judgment as they emerge during the audit process.

My personal views on external audit include the following;

1. I expect the auditors to have the respect of the audit committee and of management at all levels (evidence that the auditors have a good understanding and knowledge of the business)
2. I look to see that there has been a robust challenge of management by the auditors throughout the audit process (evidence of auditor independence)
3. I expect the auditors to communicate clearly and directly to the audit committee the "big issues" that really matter (giving the audit committee confidence in the auditors' judgement)
4. I look for a presentation from the auditors, following each audit, of how/where they have added value

Re 1, it can be very helpful for the audit committee to receive an annual report from management on how they have scored the auditors under a number of headings and whether the year on year scores are improving or worsening. As audit committee chairman and at my initiative, I now attend the auditors' annual audit planning conference where I can hear at first hand the interchange between company and auditors and form my own view of the quality of the audit team and the way they plan and implement the audit process

Re 3, the audit committee receives written reviews from the auditors at the half-year and also for the full year. However, there is sometimes still a tendency for the auditors to enlarge on management's responses to the issues rather than report them directly. My own appreciation of the key judgemental issues probably comes as much through one-to-one informal meetings with the auditor during the course of a year.

Re 4, it is for the auditors to present (rather than for the audit committee to ask) where they believe value has been added.

In my experience, it is 2 (management challenge) that tends to be the most difficult for an audit committee to measure. For large FTSE companies, it is common for the external audit team to come together at various points of the audit process to take stock, following which material issues that concern them are raised with management. It has been my experience that it is not the normal practice of the auditors to ensure that the audit committee chairman is made aware at the same time of any substantial issues that have arisen and how management is responding to them. It is not necessarily sufficient for the audit committee to be told at the end of the audit that issues are presented by management/auditors as having been "agreed", without knowing how much debate and challenge has taken place to get there

#### **5. General issues**

The reason for dwelling on my personal experience in 4 above is to provide background to what I believe should be communicated to shareholders by an annual audit committee report in place of what would be involved in pursuing A.2.4 to A.2.6. The issue I would ask the FRC to address is a cultural one - to "nudge" auditing firms and company finance directors to ensure that audit committee chairmen (and through them, audit committees) are kept informed on how the major accounting / presentation issues arising from the audit are being addressed, debated and resolved between auditors and management during the course of the audit, I believe this is necessary to help an audit committee judge the effectiveness of the auditors and the audit process as well as to improve the process by which the committee is able to judge where, in a range of conservative to aggressive, a particular accounting treatment rests.

Where an audit committee is able to report that it is properly engaged in the evaluation both of the auditors and the audit process, I believe that its annual report to shareholders should reflect this. The steps proposed in A.2.4 to A.2.6 would then not be necessary

#### **6. Regulation**

I understand that it is now not unusual for there to be up to 3 regulators on the premises of the "Big 4" at any time. One of the firms advised me that some reviews of audit files by the regulators have taken considerably longer than the audits themselves. This is bureaucracy gone mad.

I would submit that if progress is to be made on the big issues identified by the FRC, there is an urgent need to simplify/reduce the regulatory oversight to which the auditors are subject

#### **7. Auditors' liability**

I find it worrying that despite the greater prescription in accounting rules, directors' obligations to provide information to auditors, greater details in representation letters given by directors etc, the same firm told me that they believe they face a greater likelihood of being sued in the UK for audit related activity than 10 years ago.

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