

Julian Rose  
Secretary  
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Financial Reporting Council  
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## **Re: Choice in the Audit Market – Interim Report of the Market Participants Group**

Dear Julian

Herbert Smith is pleased to have the opportunity to respond to the above report. Herbert Smith has a long association with the accountancy profession, representing several of the larger accountancy firms over many years and being closely concerned with various aspects of the regulatory environment in which accountancy firms operate. We are also audited by one of the Big Four firms.

### **About Herbert Smith**

Herbert Smith is a leading and full-service international legal practice with a 1,200-lawyer network across Europe and Asia. We are acknowledged as being in the top tier in each of our main areas of work: transactions, projects and disputes. Our international capability is enhanced by our alliance with Gleiss Lutz and Stibbe, the leading Western European law firms with whom we have worked on many major cross-border matters.

### **Our response**

We begin by raising some points about the report and the FRC's work to date that we believe are of fundamental importance when considering the current and possible future make up of the accountancy market. Our response then goes on to answer the questions raised in the report, looking at each of the suggestions from the MPG in turn.

### **General points**

Herbert Smith LLP is a limited liability partnership registered in England and Wales with registered number OC310989. It is regulated by the Law Society of England and Wales. A list of the members and their professional qualifications is open to inspection at the registered office, Exchange House, Primrose Street, London EC2A 2HS. We use the word partner to refer to a member of Herbert Smith LLP, or an employee or consultant with equivalent standing and qualifications.

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We congratulate the MPG on producing a proportionate, well informed and helpful paper which recognises that any substantial and direct intervention in the audit market is likely to be counter-productive. This confirms our view that any attempt by government or regulators to break up the larger firms or in some other way substantively alter the current market is likely to give rise to all types of unintended consequences which will be extremely difficult for auditors, regulators, investors and companies subject to audit to deal with and that market-based solutions offer the best, long-term route.

We believe that government and regulators should be seeking to remove impediments in the regulatory and market environment in order to encourage the mid tier firms to grow over time and compete with the existing Big Four firms. Although the firms may grow organically, larger steps may also be taken through merger between various firms (and of course we have seen a recent example in the merger of Grant Thornton and Robson Rhodes in the UK). The fundamental principle here is that the regulator should leave market participants to work out what is in their best interests and only act to prevent market developments if these are clearly and seriously prejudicial to choice and a risk to audit quality.

Even appropriately limited actions by regulators (including some of the proposals made in the report) will require the exercise of great care and discretion, so that again there are no unintended consequences, particularly in terms of the maintenance of audit quality. In this context we have some concerns with one or two of the suggestions made, in that we believe there is a risk that audit quality may suffer as a direct or indirect consequence of some of the proposals.

**Do you support the three criteria used for assessing the merits of the particular recommendations?**

We agree, of course, that each action proposed by the report, either by itself or when combined with others, should contribute to achieving the intended outcome. Cost-benefit is also an important consideration and we would be keen to see the FRC developing better and more sophisticated criteria for assessing cost-benefit compared to the way that regulatory impact assessments are currently performed by government departments.

The fundamental issue, however, is the maintenance of audit quality: any proposed action which might risk undermining the current high standard of audit quality in the UK market should certainly not be undertaken and, as noted above, we do have some concerns that some of the proposals in the report risk exactly that. It may be that the proposals may still be carried forward, in which case certain safeguards may need to be put in place to ensure that audit quality is maintained.

**For each provisional recommendation:**

- Do you support the stated objective of the recommendation?
- Do you agree with the assessment of the recommendation or if not why not?
- What alternative or additional recommendations could achieve the desired objective in a way that meets the assessment criteria?

We have addressed each question in relation to each of the individual recommendations below.

***1 Changes to audit firm ownership rules***

We are not adverse to the idea that ownership rules should be relaxed to allow outside investment in firms. However, we are unclear whether there is a great demand by the existing audit firms in the mid-tier to take on any external financing beyond that already achieved by the firms through borrowing. Any equity investor will demand a return on their investment to commensurate with the equity risk and the pressure in some circumstances on auditor independence and audit quality may be severe. We assume that the FRC has studied the proposals for reform of legal services in the UK and the protections required when outside investment is permitted.

Moreover, there are already difficulties because of independence rules as to where external banking or insurance facilities can be obtained because firms may be closed off from certain banks or other financial institutions due to their audit work. It would seem counter-productive to require greater regulatory burdens to be put on those firms that have external investors as opposed to those that do not. We also believe that any attempt to legislate in this area would have to be achieved at least on a pan-European – or even global – basis to avoid further problems with the US in relation to independence issues. It nevertheless seems unlikely to us that the step change in investment

required by mid tier firms is constrained by the lack of ability to raise external capital in the way envisaged by the paper.

## **2     *Disclosure of financial results on work of statutory audits***

In our view the report fails to recognise what is generally a high level of transparency of the larger accountancy firms, which already publish PLC-style annual reports on an IFRS or UK GAAP basis. Although this is partly due to legal reporting requirements for LLPs, most reports go far beyond the bare minimum required by law. As part of this reporting, substantial segmental information is given. It is hard to see why firms should be subject to even more disclosure than that already given. It is not clear to us to what use any additional information would be put, other than to encourage further unwarranted criticisms by some commentators of, on the one hand, allegedly excessive earnings from audit fees or, on the other, too much reliance on non-audit work.

We believe the mid tier firms are already sufficiently aware of profitability in relation to audit services generally to enable them to make a rational decision about whether it is worth their while to invest further in order to make inroads into the top end of the audit market. We also suspect that the costs of compliance are probably higher than indicated in the report because of the changes that would be needed to firms' accounting systems as well as the level of cooperation that will have to be permitted between the firms to record and report this information on a common basis (on which point the competition authorities would need to be satisfied that there was no breach of the competition rules). There are also limits to transparency: we are concerned that some parties pushing for increased transparency may actually be looking for information which would not just be onerous to produce but actually oppressive, for example disclosure of individual partner earnings. It would also be particularly onerous to have to separate such earnings between audit and non-audit earnings. Also, non-auditors within audit firms may become subject to more onerous requirements than their equivalents in non-audit firms, e.g. consultancy practices. We would therefore wish to see further detail on what exactly is proposed under this heading so we can further consider the cost-benefit implications.

Some questions are raised by the proposal, in particular what "directly related services" encompasses. The ICAEW has experienced considerable difficulty recently in producing sensible

guidance for companies trying to comply with their legal requirement to disclose fees to auditors. Some of the problems have been about categorisation of types of work, so further development of guidance would be required in this area.

### **3 *Auditor liability arrangements***

The auditing provisions of the Companies Act 2006 have yet to come into force and Liability Limitation Agreements (LLAs) will be permitted to be put in place only for audits of financial years beginning on or after 6 April 2008. In the meantime, as companies and their auditors (as well as shareholder bodies) discuss how limitation of liability might be applied under the new Act, some guidance from the FRC would be helpful. We note the FRC has set up a working party to issue some guidance in this area, but time may become pressing depending on which AGM season will be the first to allow approval of LLAs to be placed before shareholders.

Guidance would be particularly helpful because the law is not easy to apply and it is currently unclear to audit firms which approach to LLAs is likely to achieve widespread acceptance in the market and which would, if necessary, stand up to judicial scrutiny. Obviously it would be counter productive if LLAs, once established between the Big four audit firms and their clients, introduced a further barrier to mid tier firms attempting to compete with the Big Four. Although the FRC may have a role in this area, in that it may offer some guidance to market participants before LLAs are negotiated, there is of course a backstop check where the competition authorities will step in if they believe it is necessary to do so and it is also the case of course that the Secretary of State has powers to intervene under the Act, should he see fit.

Overall then, this is an area where we believe the FRC could provide a useful "honest broker" role between companies, auditors and shareholder bodies in offering some guidance, but recognising that other regulators have the power to intervene in anti-competitive situations.

### **4 *Participation on standard setting bodies etc***

We agree that it would be beneficial if individuals from different sizes of audit firms, particularly those outside the Big Four, were to serve more frequently on standard setting bodies and other

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regulatory committees. Quite apart from issues of competition and choice, the more input that is received from different practitioners, the better standards and regulation are likely to be produced.

It should be recognised, however, that the bodies responsible for appointments have not sought specifically to exclude any non-Big Four participation; rather, firms outside the Big Four have not necessarily been able or willing to invest to the extent required in freeing up people's time - which is very expensive in many ways – in order to serve on such bodies. We therefore believe that the firms outside the Big Four need to make a commitment to invest the level of time and resource which should make it easier for regulatory organisations to appoint individuals from those firms to standard setting bodies.

It is also worth pointing out that the Big Four firms must continue to be involved with these bodies, particularly as they tend to deal with the most complex technical issues, on both the accounting and auditing front. To exclude them would lose the benefit of that knowledge and experience and produce much poorer standards and regulation as a consequence. We see no danger of regulatory capture, cited by some parties as a potential problem: as is the case with the FRC's own model for the constitution of its standard setting bodies, checks and balances - for example by keeping practitioners generally in a minority - are effective means to ensure standard setters and regulatory bodies are acting in the public interest overall.

## **5     *Transparency of the capabilities of audit firms***

We tend to the view that it is up to individual firms to promote themselves by suitable investment in business development activities, as well as investment in the actual ability to carry out a wider range of audit roles. We also believe there is a part to be played here by the shareholder bodies, as has already been demonstrated by the ABI statement on use of non-Big Four firms, so that there are public commitments from the shareholder bodies that, where the reasons are valid, companies can chose a mid-tier auditor without fear of shareholder objections.

We note the recent proposal from the AIU regarding publication of inspection reports and will respond to it separately. However, great care needs to be taken when publishing this type of

information, even with company names removed, because of company and (particularly) market sensitivities.

## **6 *Access to information from outgoing auditors***

We agree that a suitable mechanism for information to be given to incoming auditors by the outgoing auditors would be helpful. There is obviously already a certain amount of cooperation under the rules of the CCAB bodies. We see no reason why these should not be extended, subject to dealing with any legal and confidentiality issues, and in any case this is also a requirement of the Statutory Audit Directive, which must be implemented by June 2008. We suggest that it is the CCAB bodies that should continue to deal with this issue, rather than the Financial Reporting Council, although the FRC or POB will of course have an oversight role to ensure new procedures are proportionate and effective.

## **7 *Use of firms for more than one audit network***

We would take issue with the report where it states that the use of a single audit firm as helping to protect audit quality and reduce risk is something that is merely a *perception* in the market: rather we believe it is often true in many cases. There are obviously some situations where the use of more than one network is appropriate in terms of cost-benefit to the company and which can be managed to reduce risk from an audit quality perspective. However, the idea of *encouraging* companies to use firms from more than one network given some of the recent problems that have arisen – Parmalat being the obvious example – does not seem to be beneficial from the regulator's (nor shareholders') point of view in terms of audit quality. In our view the report fails to realise that as companies grow and expand their activities in breadth geographically and in depth in terms of complexity, it is often appropriate to move to a larger service provider which mirrors that greater breadth and depth, be it for audit or any other service.

We note that some participants, when responding to the FRC's 2006 discussion paper, suggested that (mandatory) joint audits would be a potential solution. We are pleased that the MPG has not followed this route as we believe that joint audits suffer from several of the problems noted above. They can harbour additional risks which militate against high audit quality and there is undoubtedly additional expense and trouble for companies which would be unfair to impose them on a

mandatory basis. It might also further restrict choice where the second firm is another Big Four firm.

## **8     *Revision of the Smith guidance***

We see no harm in this proposal but believe it is unlikely to achieve anything in particular. We believe it is probably the case that audit committees who are currently selecting auditors on the basis of quality and level of service will have no difficulty meeting the requirement, whereas others who do not put the same thought and effort in will merely produce boilerplate disclosure.

Undoubtedly some level of conservatism has taken hold within audit committees as a result of the rising risk attached to financial reporting, so finding some method of encouraging audit committees to at least look at a broader range of candidates for auditor is likely to be beneficial all round.

## **9     *Disclosure of contractual obligations***

Our experience is that restrictions on which firms may be used as auditors are extremely rare in practice in articles of association. However, they do appear regularly in finance agreements (which also usually require notification of a *change* in auditors) as the testing of financial covenants relies on the financial statements and often requires certification by auditors. The restrictions sometimes limit the company to only the Big Four firms, but they also frequently include the next few in size in the mid-tier. There is also usually scope to use any firm so long as permission is sought from the lenders. It may be important to get some indication from lenders as to how important they see this issue as it is unclear whether there are commercial drivers for this provided that lenders can be comfortable with the quality of the financial reporting. Some thought may also have to be given to banks' confidentiality requirements in their agreements with companies.

We see no harm in requiring disclosure where restrictions do exist and it would certainly help mid-tier firms to avoid wasting energy trying to obtain appointment as auditors for companies with such restrictions in place, or make them aware when such restrictions needed to be overcome. The very fact of required disclosure may also make companies and their advisers think more carefully about the issue before contracts are actually signed, thus affecting behaviour and views in advance of contractual commitments. If disclosure required an explanation for why the restriction was

required and agreed, that may also affect behaviour as and when such arrangements are negotiated in the future.

We believe that non-contractual influences play a larger role on auditor selection, whether when a company undertakes an IPO or on other significant events in corporate development. Ensuring a broader debate and awareness of the ability of mid tier firms would be the most appropriate way of widening choice here (only knowledge and experience can counter the "IBM Factor") and engaging with industry bodies, investor bodies and market participants is the key here.

## ***10 Shareholder engagement***

As is noted above, shareholders, along with all other market participants, must step up to the mark in order for some of the goals and objectives put forward by the MPG report to be achieved. We have already seen some signs of this during the development of views on this issue and we are encouraged by the continuing engagement of shareholder groups through, for example, the Audit Quality Forum.

We have some concern about the extent to which shareholders should have a direct engagement in relation to corporate transactions, be it the engagement of auditors or any other transaction. While it is quite right that good governance should prevail in all circumstances, a fundamental basis for our corporate model is the application of agency theory in the way that directors run the company for the benefit of the shareholders. Requiring some kind of vote or referendum on more and more decisions risks undermining that model. We are aware that some commentators believe the change in behaviour arising from the introduction of the advisory vote on the directors' remuneration report would also occur if one were required for the audit committee report. We are not convinced that is so, on the grounds that the reports in question are for very different purposes (the DRR vote being about how the shareholders remunerate their agents where there is a direct conflict of interest on the matter for the director agents) and there is no direct analogy between the two.

## ***11 The impact of ethical standards***

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We believe the restrictions on *firms* in the UK are proportionate and cause relatively little difficulty. The APB Ethical Standards reflect the IFAC Code of Ethics, but they move beyond it in certain areas where it is believed to be beneficial to the UK market.

This proportionate approach is not the one followed in other jurisdictions, particularly the USA, which is unfortunate when these have an extra-territorial impact. Any global firm will work to the most stringent rules, increasing costs and potentially raising another barrier to entry for other firms. The mid-tier firms may particularly suffer from some of the US "look-back" rules: although independence rules for auditors may have given them greater scope to offer non-audit services to larger companies, they then cannot take advantage of the knowledge the company now has about them to tender for the audit if that is within two years of doing what might have been a minor, one-off piece of work, the results of which would not be audited going forward.

Nevertheless, it is the *personal* requirements on partners and staff at firms which tend to cause most problems and which are most costly and difficult to manage. At the margins these are overly restrictive and even ridiculous in practice and, as well as being costly, they arguably do not contribute in any meaningful way to auditor independence. In particular, it becomes extremely difficult for partners to gain banking facilities, insurance facilities and so on when their firm has wide-spread coverage of those sectors. This is an issue therefore that the FRC should be taking forward in an international basis, particularly in conjunction with the US authorities.

## ***12 Smith guidance on independence***

We do not believe that there is such a great mismatch between what the Smith guidance and the Ethical Standards for auditors say on independence. The language in each is different, the Smith guidance being perhaps more black and white than the Ethical Standards, which allow for grey areas where judgement is required on threats and safeguards. We think the FRC might undertake some research with audit committees to see whether they are actually interpreting the Smith guidance differently from the way independence is phrased in the Ethical Standards for auditors or whether they are deliberately imposing black and white rules for their own convenience which are more stringent than either the Smith guidance or the Ethical Standards would require.

### **13 *Regulatory response to audit firm issues***

We agree with this but we think it may be quite difficult to attain. Undoubtedly excessive actions by regulators can lead to severe damage for a firm or even contributing to its failing completely as in the case of Andersen. What may be appropriate is for regulators to focus on the individuals within firms who have perhaps failed to meet the required standards while leaving the audit firm itself intact. This should of course not prevent the audit firms supporting individuals until the case has been made against them. However, in the end, no firm, however large, should be protected from the appropriate legal consequences of its own actions.

Given the move to greater transparency in reporting inspection findings, it might also be appropriate for the AIU reports to rank issues according to some materiality criteria, so that all issues are not reported as problems at the same level.

### **14 *Combined Code***

We think that this is an interesting idea, but one that needs to be considered in more detail. As already noted, many firms already produce annual reports and comment on the extent to which their governance procedures are in line with the Code. However, the Code as it stands is not suitable for audit firms as it is written for companies whose shares trade on the public market with a wide external shareholder base. Subject to opening up audit firms to outside investment, there are no external shareholders and so the whole focus would have to be different.

There are also restrictions on the way audit firms operate, many of which are statutory or regulatory, which would simply not allow them to act in the way envisaged in the Combined Code. For example, it would be extremely difficult to find external non-executives to sit on a supervisory board for an audit firm as such an individual would be required to comply with the same independence rules as the partners – including restrictions on other appointments and shareholdings.

If this was to be advanced we believe that the Combined Code should be adapted to suit audit firms and possibly also other professional firms that have to some extent a public interest remit. For

example, it would be important to define what constitutes the management of the audit firm because clearly all partners in audit firms should not be treated as the equivalent of directors in a public company. It may be helpful to look at LLPs generally in this respect as this is likely to be the most frequently used corporate vehicle for professional firms.

### ***15 Company disaster planning in relation to auditors***

We have two problems with this proposal. The first is that, were an audit firm to come under some kind of criminal indictment or other serious pressure as with Andersen, the fact that a company had a reserve auditor in place would encourage them to switch auditors more quickly than might otherwise be the case. The regulator may therefore have pushed for something which actually exacerbates the situation where the survival of an audit firm is in the balance. Secondly, we do not necessarily believe that this will work in practice because of the extent to which auditors, including stand-by auditors, are restricted from offering other services to the company in question.

Overall, companies coped with Andersen leaving the market, albeit after a hiatus, and we believe that the FRC would not be able to anticipate much of what would happen in the very fluid situation that arises after a failure. In such circumstances, regulators should be looking to ameliorate their own rules to allow other firms to step in and pick up the staff and business of the firm that has become defunct. So, for example, US regulators would need to give some kind of temporary relief to the look-back provisions in relation to independence. If these kinds of issues were agreed between regulators in advance, they could move much more quickly and in a coordinated fashion, if the event arose.

### ***Other characteristics of a more efficient market***

We do not have any other suggestions to make under this heading but would take the opportunity to point out that a number of major changes affecting auditing and auditors are due to come into force in the near future, arising from the Companies Act 2006, the Statutory Audit Directive (due to come into force by the summer of 2008) and revisions to the IFAC Code of Ethics. We believe that the FRC, along with other major jurisdiction regulators, should think about pausing in their activities to allow some of these changes to bed down.

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We are quite unclear as to where the FRC sees the end game here: over what timescale will the FRC gauge success and what criteria will it use to determine whether success has been achieved? This does not mean that the FRC should cease its activities entirely. It should certainly continue to monitor the situation and to try to shape the international aspects of this debate, but it should recognise that the number of changes that are about to come into force could have both beneficial and adverse impacts on the market and to act before these outcomes have become clear may well be counter-productive.

We would be very happy to discuss any of these points with you further. If you wish to discuss them please contact Kathryn Cearn, Hardeep Nahal or Malcolm Lomers.

Yours sincerely,

**HERBERT SMITH**