

Mr Julian Rose
Secretary, Market Participants Group
Financial Reporting Council
5th floor, 71-91 Aldwych
London
WC2B 4HN

Dear Mr Rose

Market Participants' Group Consultation

I am writing in my personal capacity as the Chairman of one FTSE 250 company and the Chairman of the Audit Committee of a FTSE 100 company, a FTSE 250 company and other private companies. Prior to December 2000, I was UK Senior Partner of PricewaterhouseCoopers and since that date have been the chairman or a non-executive director of a number of listed and unlisted companies.

I am pleased to make some comments on the consultation paper dated April 2007. Before dealing with the detailed questions in an appendix to this letter, I felt that I should make some general comments as seen from the chair of the Audit Committee:

- Whilst recognising that there are now only four major international firms, it is not clear to me that there has been any lessening in the competition amongst them. In the case of smaller engagements, or those for unlisted entities, additional competition is provided by the group A firms.
- On behalf of the Board and shareholders, in making decisions on the appointment of external auditors, the Audit Committee has particular regard to the technical quality of the tendering firm and, in the case of international businesses (probably most of the FTSE 350), to their international reach. In my experience, Audit Committees believe that audit risks can be reduced by using one firm in each location provided that that firm complies with international auditing standards and puts in place an appropriate internal communication process to ensure that all relevant matters reach the auditor's signing partner and the group Audit Committee. In my experience, the global networks established by the Big Four normally assure that this requirement is achieved.
- Most Audit Committees will consider the use of firms outside the Big Four for services such as Internal Audit, Risk Management, and specialist due diligence. I am aware that a number of firms promote themselves as strong in individual markets and I and my companies have been well served by such firms. Generally, the strength and cohesiveness of their international network makes them less attractive as the company's external auditors.
- It is for the individual firms outside the big four to consider whether they feel it appropriate to make the investment in, and assume the risks of, international auditing. Given that for most companies there is presently an acceptable choice

amongst the Big Four, I imagine that such an investment decision might be hard to justify.

- In my opinion, Audit Committees would be opposed arrangements that potentially reduce the quality of external audit in the interests of artificially increasing the number of market participants.
- The consultation paper draws attention to the risks of the failure of one of the Big Four audit firms and the dislocation that would result. It is right to consider this as a risk, but past evidence suggests that while there might be inconvenience, the dislocation may not be as great as envisaged. There was little disruption following the break up of the Arthur Andersen network. Japan has recently seen a restructuring of its audit market. During the course of the mega mergers of the 1990s, many member firms of international networks around the world changed their allegiances leading clients to find new auditors in both developed economies and the emerging markets, and this was achieved satisfactorily.
- New legislation permitting the limitation of liability for audits due to come into force in 2008 should reduce the potential for a collapse as a result of proportionate liability or liability capping in the UK
- It is important to note that as a result of the regulatory structure, there are significant inter-dependencies between member firms of the Big Four operating globally and this is not just a UK problem (if it is indeed one) nor one that can be solved by the UK on its own.

In conclusion, I submit to the Market Participants Group that in their document they have not made the case for significant change, a number of the proposals potentially weaken the quality of global audit, there is currently appropriate competitiveness within the market and the regulatory and independence requirements imposed on auditors has improved audit quality.

In the appendix I briefly comment on the provisional recommendations. If there is any further information I can provide, please let me know.

Yours sincerely

Peter Smith

APPENDIX

Brief responses to provisional recommendations

- A1.1 Ownership and audit quality are different issues. Quality is assured through regulation, including the independence of the auditor.
- A1.2 I believe that Audit Committees would expect firms to make a good profit which can support continued investment. Providing detailed information on financial results is unlikely to assist an Audit Committee greatly since the focus is on technical quality and global reach.
- A1.3 Legislation now exists that may reduce auditor liability. Audits require quality systems and good people and a firm should enter this market only if it believes the risk:reward ratio is appropriate. It would not be acceptable to use audit liability capping primarily as a tool for increasing the number of market entrants.
- A1.4 It is appropriate to encourage participation by individuals from different sizes of firms. However, participation carries with it significant cost and it would be for the individual firms to assess whether the returns from involvement were appropriate.
- A2.1 An earlier consultation process considered whether the reports of the AIU should be made public. My position on this is that the regulation of auditors should be carried out by the AIU. If deficiencies are found, then the AIU should require firms to put them right. If remedial action is not taken, the AIU should recommend appropriate sanctions. There is no merit in having each audit committee assess the results of the AIU's monitoring since they will undoubtedly not have adequate information in order to make an appropriate judgement. Either the firm is fit for purpose, or it is not, and that is a call that the AIU should be making.
- A2.2 Agreed, but there are undoubtedly liability issues that will have to be considered by those who take forward this recommendation.
- A2.3 This recommendation implies that using more than one audit firm might be appropriate. Whilst there may occasionally be places where a company's auditor is not well positioned, in general the audit committee will be looking to one audit firm to undertake the audit worldwide and, from the head office territory, make good any perceived deficiencies in overseas locations. Audit committees will generally see multiple auditors as increasingly audit risk.
- A2.4 This seems a reasonable recommendation but in practice I suspect will not do much to enhance the reputation of the Group A firms; it will be re-emphasising the general belief that they are not able to provide the international reach at the right quality level. It is not clear how this recommendation is likely to improve

the situation for smaller firms. As regards external audit, most shareholders would gain comfort from the fact that the company's bankers had mandated a Big Four firm. If the company has a problem with that, it should be argued out at the time that the loan agreements are put in place. Disclosure is not a sensible way of dealing with this.

- A2.6 I cannot see any persuasive argument for this recommendation. The oversight process is provided by the Audit Committee and explained in the Governance Statements. If any investors have difficulties with the appointment of auditors, they can make their concerns known to the company. Provided that investors use their authority to discuss matters of concern with companies (which on the whole they do) I can see no reason for the proliferation of reports and shareholder votes.
- A3.1 It is appropriate to keep these matters in balance but I can see no persuasive argument for a change in the current arrangements.
- A3.2 In my experience, Audit Committees have established satisfactory processes for determining the independence of the external auditor, including such matters as the level of non-audit fees.
- B.1 There is clearly an interdependence between the member firms of each Big Four network. That is why the results of the AIU monitoring have to be considered sensibly and, in doing that, it seems appropriate to me that consultation between the regulatory authorities in key countries may well be important in allowing the UK, for example, to come to an appropriate decision. This is a sensitive area because of the reputational damage and loss of confidence that could be caused by poorly thought out processes and ill timed disclosure, and where confidentiality should be of the same nature of that between the international regulators of financial institutions.
- B.2 As firms convert to LLPs and produce more detailed accounts, compliance with good practice on corporate governance is appropriate.
- C.1 Clearly, this is something that an Audit Committee should keep under review. However, experience suggests that if the risk arises from litigation, there is a long period of time between the matter first becoming public and its final settlement. Whilst history may not be repeated, it has so far shown that the market is able to adapt to fill the vacuum filled by a departee. The Big Four firms should not have their future underwritten by regulators, but effective audit regulation coupled with an ability appropriately to limit liability would seem to go a long way towards reducing such risks.