CHOICE IN THE UK AUDIT MARKET

Interim Report of the Market Participants Group (April 2007) issued for comment by the Financial Reporting Council

Comments from ACCA
July 2007

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Executive Summary

ACCA welcomes the opportunity to respond to the Interim Report of the Market Participants Group (April 2007) *Choice in the UK Audit Market* (the Interim Report) issued for comment by the Financial Reporting Council (FRC).

In the Interim Report, the Market Participants Group has identified and assessed possible actions that market participants could take to mitigate the risks arising from the characteristics of the market for the audit for major public interest entities in the UK.

We understand that the 'provisional recommendations' are to be viewed as 'package': combining one with another to achieve the intended outcomes, in the shorter or longer term. Accordingly, we do not attempt to compare them one with another to address their relative or indeed absolute ability to achieve their stated objectives.

Overall we conclude that the Interim Report provides a complete analysis and an accurate assessment of proposed recommendations. Our comments do not constitute either support of, or opposition to, the implementation of the provisional recommendations, however, as our views on the wider aspects of choice in the UK audit market were set out in our response to the May 2006 Discussion Paper *Choice in the UK Audit Market*.

Our comments below are divided into sections dealing with:

- The criteria used for assessing the merits of the provisional recommendations
- The provisional recommendations (individually)
- Other characteristics of an efficient market

Criteria

Do you support the three criteria used for assessing the merits of the provisional recommendations, as shown below? If not, please provide preferred criteria.

Effectiveness: **Whether actions would, when combined with others, contribute to achieving the intended outcomes:**

Quality: • **Whilst at least maintaining audit quality**

Cost: • **At a cost which is proportionate to the likely benefits and which is lower than alternatives offering equivalent benefits.**

We support the above criteria. They properly recognise the need to maintain audit quality, which is of paramount importance. Although not given explicit recognition in the criteria, there is an implicit need to ensure that recommendations do not diminish the audit market's existing effectiveness which underpins the delivery of audit quality.

The cost of the proposals will be small in relation to the magnitude of securities trading, but we agree that some regard should be had to the relative efficiency of alternative proposals.

Provisional Recommendations

INTRODUCTION

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?**

ACCA's views on the wider aspects of choice in the UK audit market were set out in our response to the May 2006 Discussion Paper *Choice in the UK Audit Market*. Our comments in this section on the objectives, and on the assessment of the recommendations, are subservient to that response and do not constitute either support of, or opposition to, the implementation of the provisional recommendations.

The objective of each provisional recommendation, as summarised on page 14 of the Interim Report, is related to the overall objective to enhance efficiency of the market for the audit of public interest entities in the UK and reduce risks to the availability and quality of audits. This overall objective is divided into three subsidiary objectives (or sections) (A, B and C) and within each section there are subsidiary objectives (or subsections) (A.1 to A.3, B.1 to B.3, and C.1 and C.2). The specific objectives of provisional recommendations A.1.1 to A.1.4, A.2.1 to A.2.6, and A3.1 to A3.2 are, therefore, linked to three higher statements of objective.

We agree with the higher objectives including those at the diagrammed 'level' A.1 to C.2. These provide an appropriately complete treatment of the issues.

In the sections below, we address the provisional recommendations individually and comments on the specific objectives of provisional recommendations A.1.1 to A.1.4, A.2.1 to A.2.6 and A3.1 to A3.2.[1]

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[1] While the above numbering reflects that on page 14 of the Interim Report, the diagram is not always consistent with the order in which the recommendations are dealt with in the text. The

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.

We agree with the assessment of the provisional recommendation. This is a difficult area and one that merits further investigation. Although the Interim Report is a directed at the audit of public interest entities, auditor independence is a matter of global importance for all sizes of audited entity and it is important that the debate is taken forwards in this wider context.

2. AUDIT FIRMS SHOULD DISCLOSE THE FINANCIAL RESULTS OF THEIR WORK ON STATUTORY AUDITS AND DIRECTLY RELATED SERVICES ON A COMPARABLE BASIS.

We agree with the assessment of the provisional recommendation. The financial results could be published separately or could receive emphasis as part of the transparency reporting by auditors of public interest entities required under Article 40 of the 8th Company Law Directive on the Statutory Audit of Annual Accounts. Our views on such reporting are contained in a separate response of October 2006 to the Professional Oversight Board.

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headings in this section of the response are numbered in the order of the provisional recommendations (1 to 15) set out on pages to 7 to 10 of the Interim Report.

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.

We agree with the assessment of the provisional recommendation. We note that the FRC has agreed to appoint a working group to provide a suggested standard form for auditor liability limitation agreements and a suggested process for the effective implementation of such an agreement. It is important that such work is progressed in the light of the knowledge that the characteristics of the UK audit market are shared with other markets worldwide. Similarly, any solutions proposed are unlikely to be successful unless they make sense in a global context.

4. REGULATORY ORGANISATIONS SHOULD ENCOURAGE APPROPRIATE PARTICIPATION ON STANDARD SETTING BODIES AND COMMITTEES BY INDIVIDUALS FROM DIFFERENT SIZES OF AUDIT FIRMS.

We agree with the assessment of the provisional recommendation. ACCA has argued both in the UK and internationally for the membership of standard setting bodies to be widely drawn. While the reasoning for this has been mainly directed at increasing the quality, relevance and national adoption of standards, the perceptions about capabilities of audit firms may also be relevant.

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.

We agree with the assessment of the provisional recommendation. As noted in the Interim Report, there are many existing initiatives relevant to the 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.

We agree with the assessment of the provisional recommendation. In due course, ACCA's Rulebook will include provisions concerning access by an incoming auditor to all relevant information from the outgoing auditor.

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.

We agree with the assessment of the provisional recommendation. The Interim Report has not specified which 'other market participants' are intended to be provided with independent guidance from the FRC. If that description is intended to encompass auditors, we suggest that it would be of particular importance to address the issue from an international perspective.

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.

We agree with the assessment of the provisional recommendation. The greater accountability of audit committees in this area may promote better consideration of the issues highlighted in within the Interim Report.

9. WHEN EXPLAINING AUDITOR SELECTION DECISIONS, BOARDS SHOULD DISCLOSE ANY CONTRACTUAL OBLIGATIONS TO APPOINT CERTAIN TYPES OF AUDIT FIRMS.

We agree with the assessment of the provisional recommendation. Although this recommendation is encompassed by provisional recommendation 8, it is worthy of separate consideration. The FRC may wish to consider whether, as well as encouraging the provision of more relevant information by companies and auditors, investors and similar market participants should also be encouraged to increase transparency. This matter could be developed in relation to provisional recommendation 10.

10. INVESTOR GROUPS, CORPORATE REPRESENTATIVES AND THE FRC SHOULD DEVELOP GOOD PRACTICES FOR SHAREHOLDER ENGAGEMENT ON AUDITOR APPOINTMENT AND RE-APPOINTMENTS AND SHOULD CONSIDER THE OPTION OF HAVING A SHAREHOLDER VOTE ON AUDIT COMMITTEE REPORTS.

We agree with the assessment of the provisional recommendation. The parallel with votes on remuneration committees' reports on executive remuneration is sufficiently important to highlight in the context of the development of good practice.

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.

We agree with the assessment of the provisional recommendation. ACCA has been consistently of the view the wider public interest has to be recognised when setting standards for independence and objectivity. There are many matters of public interest that authorities should consider when establishing ethical standards for auditors and we agree that the impact on auditor choice should be considered.

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.

We agree with the assessment of the provisional recommendation. This could be regarded as a simple consequence of any changes resulting from implementation of provisional recommendation 12, but a shorter timescale could be applied in order to achieve consistency with existing relevant ethical standards for auditors. Consistency should not mean exact correspondence, however, as ethical standards for auditors are a matter of global importance for all sizes of audited entity. There needs to be full consideration of that, but also proper recognition of the special circumstances of the UK market in any revision of the Independence section of the Smith Guidance.

13. REGULATORS SHOULD DEVELOP PROTOCOLS FOR A MORE CONSISTENT RESPONSE TO AUDIT FIRM ISSUES BASED ON THEIR SERIOUSNESS.

We agree with the assessment of the provisional recommendation. The provisional recommendation recognises the importance of global regulators and the need for global solutions.

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.

We agree with the assessment of the provisional recommendation. There are attractions to using the same Code as listed companies but the Interim Report properly indicates that appropriate adaptations would be necessary. We find the views of the Financial Services Authority, reproduced in the Interim Report, particularly illuminating in this regard.

There is potential overlap between disclosures in respect of an audit firm (which ordinarily provides services other than audit) and the transparency reporting by auditors of public interest entities required under Article 40 of the 8th Company Law Directive on the Statutory Audit of Annual Accounts. Our views on such reporting are contained in a separate response of October 2006 to the Professional Oversight Board.

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.

We agree with the assessment of the provisional recommendation.

Other Characteristics of an Efficient Market

Are there other characteristics of a more efficient market which should be considered for inclusion in the report? What additional recommendations could contribute to the achievement of these other characteristics?

The Interim Report has addressed increased choice of auditor and the linked aspects of reducing the risk of a firm leaving the market and steps to address the risks if that event occurs. This appears to us to be a complete analysis of circumstances other than those of a remote possibility[2].

Within this complete analysis, the Interim Report examines characteristics of a more efficient market in relation to each provisional recommendation. Such characteristics are detailed and specific to the circumstances of each provisional recommendation. Other than the matters noted in the section of this response headed *Provisional Recommendations*, we have no further characteristics or additional recommendations that we wish to put forward.

[2] For this purpose, events of a remote possibility would include for example, more than one Big Four firm withdrawing from the market at the same time.

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