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Dear Mr Rose

**CHOICE IN THE UK AUDIT MARKET
INTERIM REPORT OF THE MARKET PARTICIPANTS' GROUP**

The Business Law Committee is the Institute's committee which monitors developments in the rules and regulations affecting businesses generally and considers legislative and other proposals deriving from bodies such as the DTI, the European Commission and the FRC. The Committee is broadly based, with members representing different sizes of accountancy practice, industry, the investment community, and the legal profession.

ICAS supports the work undertaken by the FRC in raising the matter of limited choice in the audit market for listed companies. It is important that this is kept to the fore and the debates over the last year have certainly focused more attention on the issue. We believe it is now less likely that the 'Big 4' could become the 'Big 3' by either merger or a firm unexpectedly leaving the market, and there is less complacency concerning the existing audit firms. We also note that there has been recent merger activity amongst some non-Big 4 firms. There are no quick or easy measures, however, that can be put in place to bring forth another 'very large auditor' and, of course, the issue goes beyond the UK.

As indicated in our response in August 2006 to the FRC's initial consultation about choice in the UK audit market, we believe that this issue in general should be left to market forces. Market based measures are more likely to effect gradual improvements than regulatory changes, which may in addition have unintended consequences. There are a number of recommendations suggested in this interim report that might assist market forces, which we welcome. We agree with objectives A – C underpinning this report and our comments on the specific recommendations are detailed below.

Provisional recommendations

- 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 believe this recommendation merits further investigation, with significant issues such as public interest, accountability, independence and ownership to be considered. In our initial discussions, arguments have been raised both for and against any changes to audit firm ownership rules and the introduction of external capital. Concerns have been expressed, however, that de facto control of or even significant influence over an audit firm by non auditors could impose commercial pressures that rest uneasily with the auditors' public interest duties and their independence. We have not reached any firm conclusions on whether changes to audit firm ownership rules would be effective in broadening the market or what impact they might have on audit quality and auditor independence. Nor have we reached firm conclusions as to whether the FRC should become involved in commenting on changes in capital structure.

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

We believe that the effectiveness of this measure may be limited. Given that clients disclose audit fees there is already information available on income. In audit firms there would need to be authoritative reporting guidance to ensure comparability of results and profitability.

- 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.**

This is one of the key issues in opening up the audit market. We have long argued that developing and implementing limited or proportionate liability should assist in increasing auditor choice and that this should not be at the expense of audit quality. Companies need access to quality audits at a reasonable cost but there is a high risk attached to auditing multinational companies, which is due to the auditor being exposed to potentially very high claims compared to the profits of the auditing unit concerned and this acts as a deterrent to new entrants to the multinational market. In order to promote a choice of auditors and maintain quality at a reasonable cost we would welcome the support of regulators and legislators in the development and implementation of policy on limiting auditor liability arrangements. We note that the European Commission has published a summary of responses to its recent consultation on limiting auditor liability and we recommend this as part of the debate.

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

We agree with this recommendation. As an Institute we have always sought to ensure that participation on our committees is representative as far as possible of all our membership and can vouch for the benefits of wide participation.

We suggest that the FRC should investigate whether the payment of expenses and/ or a notional fee may help to encourage individuals from a wider range of firms and a wider geographical spread to participate. It can be expensive in terms of both time and lost fees, particularly for those based further away from London, to participate fully in standard setting bodies and committees if members are from outwith the immediate locality.

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.

Our members have expressed mixed views concerning this recommendation. Some suggest that the FRC could be responsible for promoting an understanding of audit quality drawing on input from a wide range of parties. However, others have expressed concerns that the promotion of quality may be akin to marketing and is not an appropriate role for a regulator.

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.

Practical experience suggests that most audit firms are unwilling to offer extensive access to their working papers and similar information, and there will, no doubt, be debate concerning what information is 'relevant'. This will need to be addressed, however, as part of the implementation of the 8th Directive in the UK. We put our views forward on this matter in the response to the DTI from the Joint Audit Committee of ICAEW, ICAS, and ICAI.

On the other hand, there is the valid argument that the reason for appointing new auditors is to have a fresh approach to review and question a business without previous knowledge or pre-set assumptions and, therefore, requirements for access to information should be kept to the minimum required in the 8th Directive.

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

Yes, we agree that the FRC or a body such as the Institutional Shareholders' Committee could do this. We remain unconvinced that this would be effective for the larger multinationals, whereas it may be more effective for smaller listed companies.

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 re-selection decision.

This recommendation to include a section in the audit committee report may usefully document for shareholders (on whose behalf they are acting) how the audit committee has evaluated its choice of auditor. However, there would be practical difficulties in drafting meaningful disclosures which add value to shareholder decision making. In addition, we are unsure that the suggested timing of such communications is useful.

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

We support the principle of disclosure, however, there may need to be de minimis limits, and there are also occasions when commercial sensitivities (e.g. possible due diligence work which is confidential) preclude disclosure.

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

It may be useful and effective to have good practice guidelines developed to encourage shareholder engagement in the decision making regarding auditor appointments and reappointments and we would support this part of the recommendation. However, we have reservations about requiring a shareholder vote on audit committee reports because it is unclear what the shareholders would be voting on and therefore we do not support it.

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.

Yes, we agree. The distinction between audit and non-audit services, and what non-audit work the auditor can undertake, can have an impact on audit choice. Each audit firm is bound by APB Ethical Standards regarding what non-audit services it can provide, but company audit committees tend to set their own rules, some more conservatively than others. Arguably, if the audit firm is not allowed to tender for non-audit work (which may involve considerable input and could provide income for the firm) then there may be less incentive to bid for the audit.

We would welcome an extension from five to seven years for the rotation requirements for the audit engagement partner. The practicalities of rotating partners are difficult to manage with a lead partner and his team of fellow partners on a large, multinational client and more so in specialised sectors. We believe this would be eased if the rotation period in the UK was matched with that in the IFAC code and the 8th Directive. As a minimum the five year rotation rule should at least be flexed in the event that there may also around the same time be a change of finance director or audit committee chairman. Changing all of these key appointments within a short space of time does not generally serve shareholder best interests and retention of the auditor's knowledge base in these circumstances is critical.

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.

Yes, we agree with this recommendation.

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

Yes, we agree. The scale and speed of the collapse of Andersen has acted as a warning of how quickly a professional firm, where much depends on reputation, can disappear. Good reputation is vital and audit partners are well aware of this, and they will do all they can to maintain and enhance it, without the need for external support or regulation. The key to audit monitoring and, where necessary, improving audit practices, rests upon effective cooperation between the profession and the regulator, and this can only be accomplished if the regulator responds in a consistent manner. We would prefer any regulatory measures to be based on clear, publicly available protocols which should be based on the better regulation principles espoused in the McCrory Review of Regulatory Penalties.

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.

Aspects of this will be brought into the UK by the 8th Directive, and we do not believe that the case has been made by the FRC for going beyond these.

Our members express two diverging views on this recommendation. Some say that audit firms should apply the same corporate governance as their clients. Other members consider that an audit firm is owned by its partners so the ownership is fundamentally different from a company with shareholders and, therefore, publication of corporate governance by an audit firm is inappropriate. On balance, we feel that there are already sufficient governance disclosures from existing reporting requirements. If the equivalent of Combined Code information is deemed desirable it would have to recognise that it is providing information to customers rather than shareholders.

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.

Yes, we agree and many PLCs have done this since the demise of Andersen in 2001/02. However, there is a limit to what public interest entities can accomplish with individual contingency plans should one of the Big 4 firms unexpectedly withdraw from the market. Associated planning is required by the FRC to develop a framework in which audit expertise and public entity audits can be transferred in an orderly manner to other remaining market participants in the case of a major firm withdrawal.

Please do not hesitate to contact me should you wish us to expand on or to discuss further any aspects of the above points.

Yours sincerely



CHARLOTTE M BARBOUR
Assistant Director, Accounting and Auditing
Secretary to the Business Law Committee