

**Gillridge,
Gillridge Lane,
London Road,
CROWBOROUGH,
East Sussex
TN6 1UR**

Tel: 01892-654630

Fax: 01892-610536

E-Mail: duncan_alexander@compuserve.com

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Financial Reporting Council,
5th Floor Aldwych House,
71-91 Aldwych,
London
WC2B 4HN

Attention of JEC Grant

Dear Mr Grant,

FRC Discussion Paper – Promoting Audit Quality

1. INTRODUCTION

As an investor, I am glad to see that "... *the FRC believes that users of financial reports must be able to rely on an audit report giving a robust and objective opinion that the financial statements concerned show: A true and fair view . . .*" and that this discussion paper "... *focuses on the financial reporting regime, including audit, and its ability to meet the needs and expectations of all stakeholders, unconstrained by the existing legislative and regulatory framework. . .*". I welcome your wish for the views of stakeholders including additional actions, which could improve the likelihood of audit being of a consistently high quality. I believe that you have made a significant mistake in exploring the issue of audit quality **before first resolving** the audit liability problem following the *Caparo* judgement.

My perspective comes from being a working investor creating and running small businesses and being a passive investor by investing in publicly quoted companies around the world. In both roles, I believe that the owners of business should be responsible for the oversight and development of their venture in trade and in the fact that most investors believe that the accounts of a firm are an essential tool in making business decisions.

I would suggest that the main purpose of the audit and company law should be to serve the needs of investors. It is on that basis that I submit my comments on your discussion paper and answer the questions you ask. I would like to confirm that I have made contributions to the DTI Company Law Review, the Auditing Practices Board on Aggressive Earnings Management, the Sandlers' Review Team on medium & long-term retail savings, the Treasury Committees' inquiry into the financial regulation of Public Limited Companies and to other bodies both here and abroad. I have no objection to my views being put into the public domain.

2. OVERVIEW

Many investors believe that the accounts of a firm are a key element for investors to interpret their venture in trade and exercise their governance and stewardship functions. They believe that Auditors need to:-

1. Act clearly and specifically on behalf of and in the interest of shareholders.
2. Protect the company from wrongdoing by their hired hands by providing the owners with independent reliable intelligence on the companies' affairs to aid discussions at members meetings.

It is clearly wrong that the company directors of quoted companies control the appointment and removal of auditors. The owners should do this through their presence on the firms audit committee. I welcome the moves in the Companies Act 2006 to increase the role of the audit committee and would suggest that it would be best practice for this committee to be present and ready to contribute to discussions at members meetings. The appointment, resignation and removal of auditors must be open to inspection and discussion by the owners at such meetings.

At the heart of the Audit Liability problem is the 1990 House of Lords *Caparo* judgement, which held that:-

1. Auditors do **not** have a duty-of-care to individual shareholders.
2. Auditors are only responsible for their work for the 21-day period up to and including the AGM.
3. The only sanction that shareholders have against *negligent* auditors is to replace them at an AGM.
4. The purpose of **an audit** is to provide only guidance in discussing the stewardship of the company directors at a AGM – it is **not a statement of facts**.
5. It is *unreasonable* to expect negligent auditors to be responsible to those that invest or lend money to a company.

On the one hand, many investors argue that this out-of-date, class obsessed judge-based law has *excessively restricted* the rights of owners. They have suggested that as they vote for the appointment of the auditors at an AGM and those auditors directly report to them, it should be only fair and reasonable that they should be able to rely on the auditors work for making management and investment decisions.

On the other hand, as the auditors legal liability has been considerably reduced by the *Caparo* judgement, it is not surprising and entirely predictable that the Big 4 accounting firms are vigorously opposing any extension in liability but all in favour of higher quality of information, which the owners have to pay for, but cannot rely on. Audit liability is directly related to audit quality. My suggestion is that you should concentrate on identifying the degree of auditor liability that is fair and reasonable then build the systems and processes needed to ensure that you have the audit quality to meet that liability. It is that simple!

3. Answers to your questions

Q1 *Are there other important indicators of an audit firm's culture that are not referred to above?*

Answer: No

Q2 *Are there pressures that could compromise the culture of audit firms that have not been identified above?*

Answer: No

Q3 *Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?*

Answer: Sort out the audit liability issue first – see the Overview above.

Q4 *Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?*

Q5 *Has this paper identified the key issues that could result in an inadequately trained or skilled workforce for audit – if not, what other issues are there and why are they issues?*

Answer: Yes – but the audit liability issue needs to be resolved first.

Q6 *Should there be a fundamental review of the qualification and training requirements for auditors?*

Answer: Yes.

Q7 *Are there other factors that determine whether an audit process is effective?*

Q8 *Are there threats to the effectiveness of the audit process that have not been identified above?*

Answer: No.

Q9 *Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?*

Answer: Establish the purpose and liability of auditors.

Q10 *Are there other factors that determine whether audit opinions command confidence?*

Q11 *Are there other reasons why users may not have confidence in the audit opinion?*

Q12 *Are there further steps that could be taken to reinforce confidence in an audit opinion? In particular, what changes to the form and content of the audit report should be considered?*

Answer: Resolve the audit liability issue first. If the very restrictive uses of the audit report following the Caparo judgement is to continue, there does not seem to be much point in extending the elements to an audit. It would be better for all stakeholders to realise that UK audit opinions cannot command any confidence.

Q13 *Are there other external factors that have the potential to adversely affect audit quality?*

Answer: Uncertainty over the audit liability question and reform of the law following the Caparo judgement.

Q14 *Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective?*

Answer: Owners representation on the audit committee is the only effective way to get their views and concerns about the audit function represented. These owners should have a fiduciary responsibility to the other members of the company.

Q15 *Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?*

Answer: Yes – but don't fall into the trap of thinking that you can provide effective guidance on all aspects of auditing. White collar crime is constantly evolving and we don't have the politicians with the political theory to tackle the emergence of *magagerialism*.

Q16 *Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?*

Answer: Yes – but remember we should only do this when we have resolved the reform of the Caparo issue.

Q17 *Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?*

Answer:

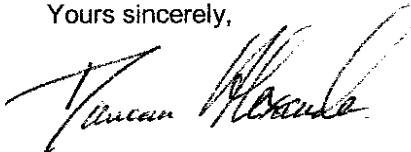
- 1. Reform Caparo.**
- 2. Make sure that the principal stakeholders – the Owners – have the right to make normal investment decisions on the audited information.**
- 3. Give the Owners proper representation on the audit committee.**
- 4. Ensure that all audit committee members are aware of their fiduciary responsibilities towards all members of the company and that they have adequate professional indemnity insurance cover.**

5. CONCLUSION

The key to reform in this area is the recognition that the Big 4 accountancy firms have cornered the market and are determined to minimise their liability for shoddy and compromised work. It is generally agreed that any further reduction in auditor choice will lead to a destruction of credibility for the audit process because of the conflict of interest problem. One of the solutions to this situation would be to add further participants to the market and declare that there should always be say a minimum of 10 firms for the market to be operational. Another part of the solution should be for the UK to return to their original position on liability, which was that unlimited liability was a spur to high audit quality.

I would be glad to expand on any of the points I have made. I will send you an email of this letter later today.

Yours sincerely,



Duncan Alexander