

Governance for Owners LLP

26 Throgmorton Street
London
EC2N 2AN
Tel: 020 7614 4750
www.g4owners.com



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Julian Rose
Financial Reporting Council
5th floor
71-91 Aldwych
London
WC2B 4HN

Dear Julian,

Response to FRC Discussion Paper on Choice in the UK Audit Market

These comments are made from the viewpoint of the shareholders in listed companies. All the points made below should be read in the context of **our overriding view that the issues surrounding choice in the UK audit market should not be addressed separately from those relating to quality of audit services in that market.**

It is easy to postulate solutions to the choice issues that could well dilute quality and vice versa. Shareholders want auditors who are strong enough to stand up to management of companies when necessary. Improvements in audit and accounting standards, the role of audit committees and the concentration of the audit market may have combined to move the balance of power in favour of the auditors. However, this is only to the benefit of shareholders if the auditors are seen to be acting in the interests of shareholders and not in their own, or management's, interests.

Before addressing the specific questions raised in the FRC discussion paper (*Choice in the UK Audit Market*) we have a number of comments to make which we believe would have a positive impact upon the overall balance of choice/quality in the UK market. We acknowledge, as does the FRC, that any changes in the UK market may not effect change in either choice or quality where there is an international dimension to audits. We do not, however, believe that the inability to change things elsewhere in the world is a sufficient argument for the UK not to attempt to lead the world on these issues. **There is a sufficient interest elsewhere in what the UK does here to expect any reforms to have a reasonable chance of being followed by other countries.**

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We also consider that there is no “magic bullet” that solves all of the issues involved. We do consider that the combination of the various suggestions in this response would, in time, have a considerable effect for good on both audit quality and choice in the UK (and later other) market(s). The Big 4 and other audit firms have argued strongly for liability reform as the prerequisite for a stable audit market. The reforms suggested in this paper are seen by us as the prerequisites for reform of “joint and several” liability for auditors.

At the heart of the debate around audit choice and audit quality is the disconnect between shareholders and auditors in listed companies that does not exist to the same extent in privately held companies where there is a multi-layered direct communication between auditors and shareholders. The advent of audit committees in UK listed companies over the last 20 years has provided the opportunity to overcome this lack of direct communication. To the extent that the audit committee, and particularly its chair, is informed about and in tune with shareholder priorities in relation to audit, it has the opportunity to ensure that the audit is designed to and does meet the shareholders’ requirements. We would like to see this shareholder-audit link improved in four particular ways:

1 The Combined Code should be amended to require a shareholder vote on the report of the audit committee similar to the vote on the remuneration committee report. We believe that this would allow shareholders to call for meetings with the audit committee chairs of companies where the shareholders considered circumstances warranted it. Such meetings between shareholders and remuneration committee chairs have had a significant impact upon the behaviour of listed companies in relation to executive remuneration. We believe that a similar impact would occur in relation to the communication of shareholder views on matters of auditor choice and quality. Indeed, our proposal would not only lead to the improvement in the quality of audit committee reports but would also allow shareholders the opportunity to influence companies’ audit committee agendas which are currently in the hands of the directors and auditors alone.

We would like the audit partner to be at such meetings of shareholders and audit committee chairs but are prepared to see market behaviours determine such attendance rather than make such attendance mandatory at this stage. We expect that audit committee chairs would want to be accompanied by auditors on many of these occasions and such chairs would differentiate firms who did and did not allow/encourage such participation by their partners. We acknowledge that there are difficult issues around auditors’ duties of confidentiality, duty of care and liability and potential market abuse which would need to be addressed before auditors are likely to feel comfortable in attending such meetings. We do not consider that the resolution of these issues should delay the adoption of the vote on audit committee reports as the auditor attendance at any resultant shareholder-audit committee chair meetings is not essential. We attach an Appendix showing the sort of issues that might be discussed at such meetings.

2 The Code should also require the inclusion in the audit committee report of a summary of the contingency plans a company has put in place to deal with the possibility of its audit firm being unable to continue as auditor. We suggest that the effect of this recommendation combined with our first suggestion above requiring a vote on the audit committee report would be to see realistic contingency plans being developed and the use of other firms for some work currently done by the audit firm becoming a normal part of such plans.

3 We recommend that the FRC (or DTI) encourage independent research into the issue of perceived audit quality of listed company audits. . To get auditors, shareholders and finance directors to contribute meaningfully to such research, we consider that it is necessary to look at “perceived” audit quality as that is the only way to overcome the very real obstacles to progress that arise from auditors’ concerns about liability in relation to any comments on quality and many shareholders’ unwillingness to engage because they see audits as “insurance policies”. Our experience is that auditors, shareholders and finance directors will have different perceptions, all of which need to be addressed.

A further area for potential independent research would be the usefulness of compulsory rotation of audits (as in Italy) or compulsory joint audits (as in France). These suggestions have been often advanced in the past and foundered on the (unproven) argument that they would increase the risk of audit failure and cost. Such research could also address what changes in laws or regulation (if any) are needed to reduce the cost of changing audit firm and reducing the risks of audit failure following such changes.

4 We would like to see a Combined Code requirement for the disclosure of the audit fees of listed companies, analysed between the fee covering the parent company and group accounts on the one hand and subsidiary company audit fees on the other hand. This would allow shareholders (and audit committees) to analyse how much the company is paying for what the shareholders see and how much is being paid for other audit services where the client is in effect the parent company board or audit committee. On the basis of this knowledge, shareholders could then address with management whether the same audit firm is needed to provide the necessary reporting to the parent company’s shareholders as the firm(s) providing the other regulatory work needed to be done for management. At present the aggregate cost of all of this diverse activity appears in the financial statements under the heading of “audit fees”. We are aware of at least one example of a listed company employing one (Big 4) audit firm to do its parent company, UK subsidiaries and group audits, using UK audit staff in overseas territories where necessary (thus avoiding the need to rely on the work of other firms), and having overseas statutory and regulatory requirements done by local firms.

It is apparent that the FRC Discussion Paper has a number of questions which seem to be designed around the bigger question of “how can we promote new entrants to the market for providing audit services to listed companies?” A major obstacle is stated to be the audit committees’ perception of quality of the “Big 4” audits as being greater than the quality of the next tier of firms and the reputation risk to audit chairs if they appoint a non Big 4 firm and “something goes wrong”. The perception centres on the numbers of people of the highest quality in each firm and the quality of the support they have rather than the quality of the very best in each firm. Given the very considerable difference in size between the Big 4 and the next tier of firms we understand why the highest quality audit staff might perceive the Big 4 as offering a better and wider experience and career than the smaller firms can offer.

With this in mind it is clear that if the non Big 4 audit firms are to become credible new entrants to the listed company audit market they will have to be seen to be behaving differently from the present in order to attract and retain sufficient people of the right calibre to demonstrate that they are “equal in quality to the Big 4”. Simply tipping the rules in favour of new entrants is unlikely to be enough to

see change on any large scale. The criticisms of some non Big 4 firms in the recent report of the Professional Oversight Board's Audit Inspection Unit tend to reinforce this viewpoint. We suggest below some actions that non Big 4 or potential new entrant firms might take in this direction.

Relaxing the rules around rotation of partners and staff would be one change that could help smaller firms but would be unlikely to improve independence and therefore audit quality, but might not worsen it significantly either. However, we return to the subject of rotation in responding to Q4 below, as **it is self evident that the rules for rotation of audit partners and staff favour the bigger firms and as such do not act to promote wider choice of audit firm.** The adoption of new rules relating to the rotation of audit firms instead of audit partners may initially appear to be more likely to be neutral or possibly helpful in terms of promoting choice than the existing rotation rules. However, unless there are changes on the perceptions of the capabilities and "safeness" of non Big 4 audit firms, rotation of firms rules may also tend to lead to an increase rather than decrease in market concentration as non Big 4 firms get replaced by Big 4 firms without gaining new clients in their place.

We note that many of the questions posed by the FRC Discussion Paper contain an implicit equality of interest in the outcome for diverse groups (investors, companies, auditors, lawyers, investment bankers, and other advisers). We refute that implicit message. **Rather, we would argue strongly that the primary responsibility of the auditors is to shareholders to whom they report and that any other parties' views are subordinate to the views of shareholders.** Indeed, we can envisage circumstances where the views of investment bankers and other advisers on auditor choice will tend to reinforce management views that might not be aligned to shareholder views. Throughout this response we use the term "shareholder(s)" rather than investors and we consider it is the companies' shareholders rather than investors in general who have the primary interest here.

We have suggested previously, as a contribution to the debate around auditor liability, **the introduction of minimum capital requirements for audit firms carrying out listed company audits,** with the minimum capital related to the audit fees of listed company audit clients. Such requirements would provide increased transparency around the financial health of the audit firms. In time, such rules might also help to create the conditions for the emergence of fully capitalised audit firms where the funding is provided by financial institutions such as pension funds, separate from the accounting professionals providing the audit and management expertise. Such a solution might take years to emerge but it would align shareowners' and auditors' interests and might even be welcomed by audit firms if it was linked to the introduction of proportional liability.

We argue in response to Questions 6 and 7 in the Discussion Paper that these rules could provide regulators with a potent weapon in the event of an imminent "4 to 3" scenario. **By requiring disproportionate minimum capitals for undue concentrations of audit client, the minimum capital requirements could be designed to make it easier for partners and staff of a failed or failing firm to have a credible alternative firm to move to, other than one of the remaining Big 3, thus creating an environment where a potential "4 to 3" becomes "4 to 4" or "4 to 5".** The market solution to the demise of Arthur Andersen saw most audit appointments follow the people to where they moved. We suggest later in this paper that further independent research into this might be helpful to regulators' contingency planning for a "4 to 3" scenario.

We suggested above that non Big 4 firms might need to be seen to be different in order to overcome some audit committees' perceptions that they are not credible candidates for appointment as auditors. This might best be done by some existing firms collaborating in some sort of joint venture ("Big 5 LLP") which delivered audit services only to listed companies. Such a venture could be partially financed by interested shareholder institutions, have outside directors and have a separate audit only culture distinctive from both its constituent firms and the Big 4.

The rest of this letter contains responses to the questions posed in the Discussion Paper. In many cases the points made above are repeated as being relevant answers to the questions.

Q1 Do you agree that the focus of the debate should be on the degree of choice in the audit market for audit services to large public companies, rather than other features of the market ?

As stated above, we do not believe that audit choice should be addressed separately from audit quality. We do support the proposition that the audit choice issue is one relating to listed companies.

We have made suggestions above for how the FRC or the DTI might encourage independent research into the issue of perceived audit quality of listed company audits. We consider that such research could greatly help regulators and government prepare for a possible "4 to 3" scenario as well as provide a basis for achieving agreement between shareholders and audit firms on how to deal with the audit firms' requests for a solution to the unlimited liability issue.

The ICAEW has made a contribution to the audit quality debate with its Audit Quality Forum (AQF). We see merit in the ideas underpinning the AQF being taken up by the FRC with a similar but more independent unit being maintained under the aegis of the FRC. If the FRC was setting the AQF's agenda and direction, fewer could argue with its output which might otherwise be too easily dismissed as being a lobby group for the accountants.

Q2 What do you regard as the most important criteria for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market ?

As stated above, we do wish to see maintenance of audit quality as a criterion for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market. We would also support changes that make the auditor appointment process more transparent to shareholders. Our recommendation above concerning the vote on audit committee reports would contribute to improving that transparency.

Q3 We invite views on how different groups, acting individually or collectively, could increase the propensity of non-Big Four or new firms to seek to be major players in the market for audits for large companies....

It is hard to see why the Big 4 firms would want to behave in a way that improved the prospects for a non Big 4 or new entrant, unless they are seriously concerned over the risks and potential liability issues that would flow from a "4 to 3" scenario.

Non- Big 4 firms could identify particular segments of the market where they considered that the scale and reach of the Big 4 firms' international organisations did not provide them with an advantage because of the lack of or limited international scale of the companies' operations. There may be segments of the market where the non Big 4 firms have significant lists of clients who are not listed. As stated above, however, this is of itself not sufficient to bring about change. Such firms would also have to demonstrate that they were behaving differently from the recent past in order to overcome finance directors' and audit committees' perceptions of a Big 4 appointment being safer or likely to produce a higher quality audit.

The biggest challenge for non Big 4 firms is how to provide a fuller range of listed plc experience to the entire audit team in advance of a step change in the number of listed company audits they have. This provides a challenge to these firms both as regards attracting and retaining the best people and in terms of demonstrating to prospective clients a sufficient depth and breadth of talent and experience as well as international reach. The scale of the technical, marketing and sales support departments in the Big 4 firms far exceeds what exists in other firms too. With invitations to audit tenders frequently being set in terms agreed by a Big 4 firm and the audit committee or Finance Director without influence from shareholders, the effect of the scale of such support is a big hurdle for the smaller firms to overcome.

It may be that non Big 4 firms could best overcome the above problems by combining either formally or to form a joint venture ("Big 5 LLP") rather than trying to attack the market alone. Such a joint venture could be focused solely on listed and big company audits and be staffed by partners and staff transferred from or on secondment from the constituent firms. Creating an audit-only joint venture for listed clients would not have the same cultural obstacles, as would a full-scale merger between non Big 4 firms. Such a new looking venture might also prove more attractive to new recruits from Big 4 firms than existing audit departments in the non Big 4 firms. It may also be that there are large pension funds which would see the financing of such a venture as being in their long-term interests as shareholders in listed companies.

Improving the transparency of audit appointments and appointment processes to shareholders might increase the propensity of non Big 4 firms to seek to be major players in the market. On the other hand, it might reinforce current perceptions that "there is no point in trying". We would support increased transparency around the audit appointment and the interaction between the auditors and the audit committee in the audit committee reports. Over time this would lead to increased dialogue between companies and interested shareholders on the subject of audit appointments and terms of engagement which in turn would make it clearer to new entrants what was required.

Shareholders' preferences in relation to auditor appointments would become clearer if our recommendation above for the introduction to the Combined Code of the need for a shareholder vote on the audit committee report were adopted. Such a change would create the opportunity for dialogue between companies and shareholders on the subject of audit or appointment which could have as big an effect thereon as the remuneration report vote and related dialogues have had on executive remuneration.

Lawyers, bankers and other advisers have no direct locus in the appointment of auditors but do have the opportunity to influence directors who are making such appointments. Probably it is the usual stance and influence of investment bankers in relation to companies contemplating fund raising or major transactions involving shareholder circulars that provides the most significant barrier for non Big 4 firms from advisers. Such attitudes are only likely to change if the bankers can be convinced that a non Big 4 firm is behaving differently from the recent past so as to allow the banks to believe that such attitudes are no longer valid. We have suggested above that this might most easily be achieved through a joint venture among non Big 4 firms.

Q4 We invite views on how the propensity of companies and their audit committees to purchase audit services from non-Big 4 firms could be increased by

....

We reiterate our views expressed above that increased transparency around the audit appointment process and creating an avenue for dialogue between shareholders and audit committees would both assist in this area, albeit that such reforms by themselves may not be sufficient to change the level of choice in the market. We suggest that shareholder groups who availed themselves of the opportunity to talk to companies about auditor appointments may well be inclined to favour the inclusion on tender lists of non Big 4 firms and be interested in learning why they were not able to be recommended for appointment. At present such information is very obscure and as such it is harder for new entrants to learn what they need to do in order to "do better next time".

We also repeat our view that unless non Big 4 firms (or combinations thereof or joint ventures between them) can demonstrate that they are behaving differently from the past it will be hard for company directors and other advisers who influence them to have any propensity to overcome their perceptions of the advantages to their reputations offered by Big 4 appointments. Who is going to want to "take the risk" of choosing a non Big 4 firm for reasons of improving choice in the market for the public good? Such directors will need to have new evidence or they will carry on behaving as they have done in the recent past.

The rules on rotation of audit partners and staff must of themselves act in favour of the Big 4 who have more eligible partners and staff available for each rotation than smaller firms. The rules, therefore, act as a deterrent to increased choice in the audit market, although, as suggested above, it is not clear that the compulsory rotation of audit firms would necessarily lessen market concentration.

We have suggested above that independent research into perceived audit quality/failure would help in this area. The arguments against auditor change on the grounds of cost and the increased risk of audit failure in the first year(s) of a new auditor need to be independently examined. The results may or may not support the argument but directors and shareholders alike would have a better basis for decision making in relation to auditor appointment.

The Professional Oversight Board of the FRC is consulting separately on the publication of the reports by regulatory inspectors. We consider that the audit committees of companies whose audits have been inspected should be entitled to such reports and should refer to such reports and how they have responded to them in the next annual audit committee report to shareholders. This would then be a subject that would be part of any dialogue with shareholders. We are not

convinced of the advantage of any wider circulation of such inspectors' report if our other suggestions for improving the transparency around auditor appointments are implemented.

There is a disruption to the finance functions of companies with a change of auditor related to the new auditors "learning about us". It is hard to see how this can be significantly reduced without addressing some difficult liability issues. If outgoing auditors were required to pass on to their successors all (or specified pieces) of their documentation relating to, for example, their understanding of the client businesses, the analysis of risks, the audit approach and major audit judgements and papers presented to audit committees, without taking on any additional risk or liability in respect of how the new auditor uses it, auditor transition would be smoother for the new auditor and company alike.

Q5 We invite views on:

- a. the combination of steps that would be most likely to lead to increased choice*
- b. whether these steps could be taken forward by market participants, or whether existing laws and regulation may constrain or prevent this*
- c. the costs of the steps relative to the risks arising from the existing or potential degree of concentration in the market.*

It is unlikely that a single change will, of itself, bring about a change in the level of choice in the market. There is no "magic bullet" that solves all of the issues involved. We do consider that the combination of the various suggestions in this response would, in time, have a considerable effect for good on both audit quality and choice in the UK (and later other) audit market(s).

Q6 We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market, including steps by...

Q7 We invite views on steps that could be taken to mitigate the effects of a voluntary or involuntary withdrawal of a firm from the audit market, including steps by ...

Both questions 6 and 7 contemplate the possible or actual withdrawal from the market of an existing Big 4 firm similar to the disappearance of Arthur Andersen in 2002. Since then there have been the "scares" of something similar occurring following the regulatory action against KPMG in the USA and against PWC in Japan. The sudden and quick demise of AA showed how efficient the market was in delivering a solution, albeit one that resulted in reduced auditor choice. In the short term following the demise of an existing Big 4 firm there would, in the absence of regulatory intervention, most likely be a similar 4 into 3 market solution, albeit that some companies might find it hard to get a Big 3 auditor because of conflicts of interest and independence rules.

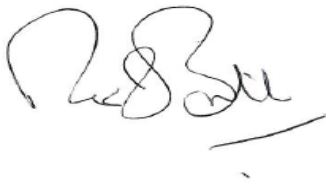
The challenge for regulators here is to put in place an environment whereby many of the partners and staff of the failed firm can move into either a new firm, an existing non Big 4 firm or a combination of existing firms. The AA scenario showed how quickly the market could move and any regulatory intervention to change the playing field in such a scenario would need to have been largely completed in advance of such a scenario occurring. A study of exactly how AA partners and staff moved to where and how AA audit clients dealt with the "loss of auditor" would

help the FRC/DTI in preparing for a "4 to 3" scenario. Such an approach to risk management by the FRC would be similar to that long taken by the FSA and the Bank of England in the banking sector.

It is precisely in this scenario that the "minimum capital requirements" for listed company auditors suggestion made earlier in this response could be "tweaked" to tilt the playing field in favour of a new firm ("4 to a different 4") rather than a 4 to 3 outcome.

I hope that these comments are helpful. GO looks forward to discussing them further with you and your colleagues and to participating in the next stakeholder forum in September.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Peter Butler". The signature is fluid and cursive, with a horizontal line underneath.

Peter Butler
Chief Executive

A handwritten signature in black ink, appearing to read "Eric Tracey". The signature is cursive and includes a checkmark at the end.

Eric Tracey
Advisory Board Member

Appendix to Response to FRC Discussion Paper on Choice in the UK Audit Market

Matters that shareholders might wish to raise in discussions with Audit Committee Chairs

- 1 The audit committee
 - The range of skills of the committee members
 - The results of the performance review of the committee
 - The committee's meeting and what they covered
- 2 The appointment of the auditors
 - Frequency of tenders
 - Process, who is invited, what is asked for
 - The engagement letter
 - Contingency plans for possible loss of auditor
- 3 The scope of the audit
 - Segmental reporting
 - Shareholder issues that might broaden the audit scope
- 4 Key judgements discussed by auditors with audit committee
 - Material issues affecting the numbers
 - Material issues affecting internal controls
 - Major issues raised by the auditors and the company's response
- 5 Independence and potential conflicts
 - What did the audit committee consider?
 - Any changes in key audit partners, worldwide?
 - Matters discussed with the auditors when the executives were not present
 - Reports by independent regulatory inspectors
- 6 Fees
 - Analysis of fees between group and other companies