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Dear Julian

DISCUSSION PAPER – CHOICE IN THE UK AUDIT MARKET

Standard Life Investments is a wholly-owned subsidiary of Standard Life plc. We manage investments which had a value of £119 billion as at 31 December 2005.

Choice in the UK audit market is important for us because, in fulfilling our responsibilities, we rely on audited financial statements. Therefore, we welcome the opportunity to comment on the matters raised in the May 2006 Discussion Paper.

The many and varied aspects which are relevant to understanding UK audit market conditions and to finding solutions which will improve choice, are often interlinked. Therefore, rather than compartmentalise our comments by responding directly to the questions posed, we submit composite comments, which we look forward to discussing with you.

Defining the problem

As professional long-term investors, we are worried – and have been for several years - by the lack of choice and its consequences. In the shorter term, we are worried in particular about:

- the apparent inability of the major firms to obtain adequate insurance cover;
- the implications of lack of choice for audit quality;
- the recognition that regulators and investors are reluctant to take action which might lead to a further reduction in choice; and
- the potential adverse implications for capital markets and investor confidence if there is a further reduction in choice.

In the longer term we are concerned to ensure that steps are taken to:

- provide solutions which will endure and stand the test of time;
- yield audits which are useful and reliable; and
- restore the relationships that should but don't exist between auditors and investors.

Certain of these concerns can be addressed by changes in the UK alone but some will only be remedied if there is a global agenda for change.

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Is a market solution feasible?

A market solution is undoubtedly feasible but it is questionable whether it will come to pass sufficiently quickly without there being a catalyst for change. The situation is time critical – the rapid demise of Arthur Andersen illustrates why we cannot be complacent. Market forces can move quickly to achieve some progress but the evidence to date suggests that authoritative encouragement and/or regulatory intervention is required to create the conditions that are conducive to achieving a market solution.

The aspects which can be addressed by market forces include:

- the attitudes of investors and other stakeholders;
- the accountability of auditors to investors; and
- enhanced communication by audit committees.

The aspects which may require regulatory or other intervention include:

- liability reform for auditors;
- the provision of insurance cover; and
- changes to ownership rules.

These aspects are covered in the comments that follow.

How to promote change

Let us focus on 4 key constituents.

1. Auditing firms

Auditors are elected or re-elected annually by investors. But over the years we have been struck by the failure of audit firms to engage investors (and, truth be told, vice versa) to explain the governance and dynamics of their firms as well as to improve their understanding of investors' requirements and expectations of auditors. The consequential communicative vacuum has contributed to:

- investors taking voting and investment decisions which are not always well informed;
- a two-way expectation gap. Investors have tended to develop unrealistic expectations of auditors and audits. In turn, auditors have tended to lose sight of how investors use – and sometimes don't use – audit reports and audited information;
- a tendency for audit firms to focus solely on companies as their clients; and
- a lack of accountability of auditors to shareholders and investors.

Therefore, primarily as a matter of good business practice but also to enable informed choice, audit firms who audit or aspire to audit public listed companies should engage systematically and at least annually with major investors in public listed companies. The engagement should cover:

- the governance of the audit firm and changes thereto;
- the audit firm's financial position and prospects;
- a review of the key factors which influence the quality of audits undertaken by the firm;
- a review of the risk factors associated with the audit firm;
- a review of the audit firm's client profile;
- the audit firm's position on key policy issues; and
- the issues the investors want to raise with audit firms and vice versa.

In addition, auditors of publicly listed companies should be required to disclose their investor engagement policy and how it has been put into practice. The firm's investor engagement policy should come within the scope of the regulatory oversight reviews.

2. Audit committees and boards of directors

Useful improvements flowed from the Smith Report. However, there is scope for further improvement in the context of auditor change. In particular, the following improvements should be made:

- When an auditor is due to be changed, the audit committee should communicate with the company's major investors to explain the reasons for the change. The recent press release about competition in the audit market by the Association of British Insurers reflected the willingness of its members to be consulted (ABI News Release 14 June 2006 Ref: 48/06).
- When an auditor is changed there should be a timely regulatory disclosure of the change and of the process which was followed to select the new auditor. The process should be disclosed in sufficient detail to provide investors with a useful understanding of how the audit committee fulfilled its responsibilities.

It has been suggested by some commentators that the audit committee report should be subject to an annual advisory vote by shareholders. We considered this suggestion but concluded that it would be inappropriate, inefficient and ineffective. We question:

- whether such a vote would improve the quality of reporting by audit committees. Indeed, it might encourage audit committees to adopt a boiler plate reporting style, which would be a retrograde development; and
- whether such a vote and the anticipated incremental engagement would contribute to the objective of achieving increased choice in the UK audit market.

Last but not least, we are concerned that such an advisory vote might encourage institutional investors to micro-manage the board and audit committee policies and practices to a degree which is undesirable and inappropriate.

3. Investors

The Oxera report states "in general, investors are rarely asked directly by audit committees what they think about an audit firm – it is simply assumed that they would prefer a Big Four firm." Also, it states that investors are "generally reluctant to interfere in auditor choice". Addressing these aspects with a view to engaging investors in the auditor selection process to an appropriate degree should help to encourage competition and choice in the UK audit market as well as helping to ensure that the company's choice of auditors reflects the views of its owners as well as its board and management.

This means that investors need to be prepared to participate when consulted regarding the election or re-election of auditors. Major investors should identify a principal point of contact to whom audit firms and companies can focus their engagement. Such a 'point person' should be competent to engage responsibly on auditing matters.

In addition, investors should adopt, disclose and implement policy guidelines regarding their approach to auditor selection by companies and to voting on auditor-related resolutions at shareholder meetings.

The Institutional Shareholders Committee should consider incorporating relevant provisions in its Statement of Principles in order to give authoritative encouragement to investors to take these steps.

4. The Financial Reporting Council ("FRC")

In promoting choice in the UK audit market, the FRC has a dual role – that of enabler and of monitor.

In fulfilling its role of enabler, it should develop a comply or explain principles-based Statement of Best Practice which can be attached to the Combined Code and incorporated therein when the Combined Code is next reviewed. The Statement of Best Practice should incorporate relevant suggestions set out in this letter and others which emerge through the current consultation process. We strongly prefer this light-touch approach for market-led change to the introduction of more onerous regulatory requirements.

In addition, the FRC should monitor on the implementation of the Statement. It should take appropriate steps to ensure that the key players are implementing the Statement in a responsible manner. It should report annually on the implementation of its Statement and be prepared, in exceptional and appropriate circumstances, to 'name and shame'.

In respect of the catalysts for market-led change which may require regulatory intervention, the FRC should consider the following and make such recommendations as it deems appropriate:

- liability reform in general, and the implementation of relevant provisions in the forthcoming Companies Bill;
- the insurance market relating to audit services – in terms of the availability of insurance cover, the degree of competition and choice in that market and the extent of choice in the broker market. In addition, it may be relevant to consider whether the adequacy of insurance cover should be professionally and publicly certified in accordance with regulatory guidelines so that investors and others can be re-assured in this regard;
- what makes an audit useful to investors. It might, for example, emerge that a move towards more customised audits could result in not only more useful audits but also more scope for audit firms to compete and thereby improve choice (note that a dialogue between global auditors and global investors is now underway); and
- the legal and regulatory provisions relating to the ownership of audit firms. It is unclear to us whether or not these provisions represent a real or perceived barrier to improving audit choice. We suggest that the subject lends itself to a considered and authoritative study to help the FRC make informed recommendations.

The need for global outreach

Addressing effectively the issues raised in this letter may go some way to creating conditions which are conducive to improving choice in the UK audit market but to achieve progress, especially in respect of choice in the UK audit market for large companies with international audit requirements, it is important that the FRC reaches out to its global counterparts and others who have a bearing on the issue. The FRC is well positioned to provide leadership and support to regulators and agencies in other jurisdictions who are seeking a solution to similar issues.

Conclusion

The lack of choice in the UK audit market is a matter of concern. The status quo feels fragile. The demise of one of the remaining Big 4 firms is a predictable accident but nobody knows when it will occur and what its consequence will be.

We have set out a number of market-led suggestions which, with some encouragement from the FRC and others, can be implemented expediently and at minimal marginal cost. When implemented, these suggestions and others will go some way to creating a climate which is conducive to improving choice in the UK audit market.

Although market-led solutions will make a useful contribution to improving choice in the UK audit market, we are sceptical whether, of themselves, they will make a significant difference in the foreseeable future. They need to be supplemented by a review of a number of the regulatory and structural factors that impact on such choice as well as other aspects, such as the state of the insurance market for auditors.

The benefit which can accrue from achieving global consensus on some of the key issues should not be underestimated. We encourage the FRC to invest appropriate resources and leadership to achieve this consensus.

We hope that, directly and indirectly, our views and comments will assist you in shaping the agenda for the stakeholders' meeting on 18 September and in finding solutions which will be successful and stand the test of time.

Yours sincerely

Guy Jubb
Investment Director, Head of Corporate Governance