



Financial Reporting Council

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Lord MacGregor of Pulham Market
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30 June 2011

Dear John

Auditors: market concentration and their role

We welcome the Economic Affairs Committee's report on *Auditors: market concentration and their role*. This is a comprehensive report which focuses on the importance of high quality audit to UK plc. We were particularly pleased to see that many of the recommendations made are in line with the FRC's proposals on audit committees in our recent paper *Effective Company Stewardship*.

The report echoes the FRC's concerns about concentration in the audit market. As the report notes, attempts by the FRC and others to address this concentration through voluntary actions by market participants have had minimal impact on market structure. We therefore welcome the Committee's recognition that it is now time for competition authorities to look into the audit market. The OFT has already begun to do this and we stand ready to provide any assistance that may be of use. We agree that such an inquiry should cover "Big Four only" clauses, liability reform and ownership. We further believe that it should look specifically at the risks of a large firm leaving the market as well as the issue of hyper-concentration in particular sectors (eg banking and insurance, where there is effectively a Big Three or Big Two).

We would note however that some matters the Committee recommends the OFT consider: in particular, expanding the scope of statutory audit and imposing further restrictions on the provision of non-audit services; would appear to fall within the remit of the FRC and its operating bodies, and we comment on this in further detail in Appendix A.

We were pleased to note the Committee's support for our proposal that the abolition of the Audit Commission be used as a catalyst to increase competition in the audit market. It is rare that such an opportunity presents itself and we believe that this has the potential to have a significant impact on market concentration.



It is important that any actions taken as a result of the Committee's report are aligned with international developments. We note in particular the upcoming publication of the European Commission's proposals on audit.

In Appendix A we comment in detail on those recommendations which are likely to involve specific action by the FRC.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Sarah Hogg', written in a cursive style.

Baroness Hogg

Chairman

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APPENDIX 1: FRC COMMENTS ON SPECIFIC RECOMMENDATIONS

We recommend that:

- (i) audit committees should hold discussions with principal shareholders every five years;**
- (ii) the published report of the audit committee should detail significant financial reporting issues raised during the course of the audit;**
- (iii) they should also explain the basis of the decision on audit tendering and auditor choice; and**
- (iv) the FRC's UK Corporate Governance and Stewardship Codes should be amended accordingly.**

The FRC's paper Effective Company Stewardship proposed greater investor involvement in the audit process via one of two routes:

- (a) discussions with principal shareholders on the choice of auditor; or*
- (b) fuller reports by audit committees including information on their oversight of the external audit process and the appointment of the external auditors.*

Feedback to our paper has indicated that the proposal in (a) is a controversial one and there is widespread opposition amongst corporates to any direct investor involvement in the auditor appointment process. There are other concerns that a formal requirement for dialogue with principal investors may breach a fundamental tenet of company law: equality for all shareholders.

In view of this we propose a fuller audit committee report together with an expectation that audits will be put out to tender every 8-10 years. We suggest this be on a "comply or explain" basis rather than mandated via legislation. We would stress that companies should remain open to approaches from shareholders who wish to discuss external audit arrangements.

We believe that every bank should have a properly constituted and effective Risk Committee of the Board. It should be one of the duties of the external auditor to ensure that this is done, by making clear that if it is not, the auditor will say so in a qualification to the accounts. This is best dealt with by rules made and guidance issued by the FRC rather than by being made a statutory requirement. Reference should however be made to it in legislation on the relationship between financial supervisors and auditors, to which we return later in the report.

We are supportive of the role of risk committees in banks and other systemic institutions. Our discussions with stakeholders indicate that there is little support for mandatory committees outside of the financial sector.

Given its applicability to the financial sector only, this is not a matter for the FRC, which is rather the custodian of those rules and guidance which relate to all listed companies. We would suggest that rules on this be set instead by the FSA and its successor bodies, who will also be responsible for supervision in this area.

The FRC is currently reviewing the way risk is handled in corporates more generally and is considering whether, in light of the review's findings, the Turnbull Guidance requires updating.



We support greater dialogue between supervisors and auditors, although we note the Government's reluctance for this to be put on a statutory footing. The AIU will look at this aspect as part of its inspection work.

We recommend that the Government and regulators should promote the introduction of living wills for Big Four auditors. These would lay out all the information the authorities would need to separate the good from the failing parts of an audit firm so disruption to the financial system from a collapse would be minimised.

We support the introduction of living wills and are working with BIS and the firms on developing these. However, we believe that to be most effective this should not be a standalone initiative and should instead form part of a wider contingency plan.

The regulation of accounting and auditing is fragmented and unwieldy with manifold overlapping organisations and functions. This is neither productive nor necessary. Other professions have only one regulator – medicine for example under the General Medical Council. The wider powers sought by the Financial Reporting Council would go some way to simplifying and streamlining matters for audit. But further impetus needs to be given to rationalisation and reform. We hope and expect that the profession will provide that impetus. In the absence of rapid progress, we recommend that the Government stand ready to impose a remedy

We welcome the Committee's support for the need to address the fragmentation of audit regulation and the FRC's powers. We strongly believe that our current structure should be simplified, not least to reduce the risk of overlapping and disproportionate regulation. We also believe that the regulation of the audit of public interest entities should be wholly independent and that this is not adequately safeguarded by the current overlapping responsibilities of the FRC and the profession

Working with the Department for Business and in consultation with the profession and other stakeholders we will publish our proposals for FRC reform shortly and we hope that they will address the Committee's concerns about the regulatory architecture in this market. The proposals are aimed at strengthening and simplifying the FRC's role and are designed with the following outcomes in mind:

- *A streamlined and more effective structure*
- *The ability to secure and communicate information more quickly and effectively*
- *More independent supervisory and disciplinary arrangements*
- *Effective and proportionate sanctions*
- *A sharper focus for the FRC's regulatory activities*
- *An accountable and secure basis for FRC funding*

We recommend that the profession, regulators and the Government should all seek ways to defend and promote the exercise of auditors' traditional, prudent scepticism. The Government should reassert the vital role of prudence in audit in the UK,



whatever the accounting standard, and emphasise the importance of the going concern statement.

We welcome the Committee's recognition of the importance of auditor scepticism.

It is important to distinguish between prudence, which is an accounting concept, and scepticism, which relates to audit and auditor behaviour.

Prudence is the inclusion of a degree of caution in exercising judgements, but it is not a reason for creating excessive provisions, which would lead to financial statements that are no longer neutral. Prudence continues to underlie the preparation of accounts and the ASB and APB have considered this as part of their upcoming statement on the 'true and fair view'. As this paper makes clear, accounts have to comply with accounting standards and these will normally result in a true and fair view. However at the end of the accounts preparation process both those charged with governance and auditors have to stand back and ask themselves whether the accounts do give a true and fair view. If they have concerns, perhaps because in their view an accounting standard does not allow them to make appropriate provision, at least the accounts need to contain proper disclosures of the issue and the accounting effects. Where exceptionally this is not sufficient the "True and Fair" override option in the law remains available and the FRRP has made it clear that it will be reluctant to substitute its own judgement for that of the Company's Board in such cases.

The FRC's work on auditor scepticism continues. In March 2011 we published the results of our 2010 consultation paper Auditor scepticism: raising the bar. Following on from this we have embarked on a number of initiatives aimed at promoting auditor scepticism and will be a continued focus for AIU inspections.

Achieving general agreement on IFRS could be a long and uncertain process. In the meantime, we recommend that the Government and regulators should not extend application of IFRS beyond the larger, listed companies where it is already mandatory. Continued use of UK GAAP should be permitted elsewhere, so that the basis of a functioning, alternative system remains in place in case IFRS do not meet their aims.

The ASB consultation on the future of UK GAAP has just closed and we are in the process of reviewing the feedback received. In coming to a decision on a way forward we will take into account the views of the Committee and the Government on the extension of IFRS.

We are not convinced that a complete ban on audit firms carrying out non-audit work for clients whose accounts they audit is justified. But we recommend that a firm's external auditors should be banned from providing internal audit, tax advisory services and advice to the risk committee for that firm. We also recommend that the Office of Fair Trading should examine whether any other services should be banned from being carried out by a firm's external auditors.

We share the Committee's concerns about auditor independence in relation to the provision of internal audit and tax advisory services to companies they audit. We also agree that auditors should not give advice to risk committees of companies that they audit. We are also conscious that the



provision of such services by accountants other than a company's auditor should help to open up competition in the market.

Although independence requirements for auditors in the UK have for some years been stricter than international standards and services which are considered to pose the greatest risk to independence are already prohibited, the standards in relation to the provision of non-audit services have been and are continuously under review – in particular because of the changing ways in which advisory services are sought by and provided to companies. .

Most recently, in October 2009 following a report by the Treasury Select Committee, the Auditing Practices Board (APB) consulted on whether the rules should be tightened further and in particular whether there should be a prohibition on auditors providing any non-audit services to the entities that they audit.

There was no support from any stakeholder group for a complete ban on non-audit services. However there was support for greater transparency in this area to address concerns regarding a perceived lack of independence.

As a result of this consultation the APB amended the Ethical Standards for Auditors in relation to the provision of non-audit services by further limiting the circumstances in which auditors may provide tax advisory services to the companies they audit (the provision of internal audit services is already prohibited save in the most minor circumstances). In addition, the APB revised the disclosure requirements in order to improve transparency and governance in relation to the types and amounts of non-audit services provided.

These changes only came into effect in December 2010 and so the effects of those changes will not be seen until companies report on financial periods ending 31 December 2011 or later.

The APB plans to review the effectiveness of its recent proposal in the light of the Committee's recommendations and experience in practice. It will also take account of any proposals by the European Commission arising from its Green Paper on audit.