



FINANCIAL REPORTING COUNCIL

CHOICE IN THE UK AUDIT MARKET

SECOND PROGRESS REPORT

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Executive Summary

This is the second Progress Report on the implementation of the recommendations of the Markets Participants Group (MPG).

The implementation of the MPG recommendations forms part of the FRC Audit Market Choice project, which aims to mitigate the risks to confidence in corporate reporting caused by concentration in the audit market for large companies.

The FRC established the MPG, which consisted of investors, companies and audit firms, to provide advice on possible actions that market participants could take to mitigate the risks arising from the characteristics of the market for audit services to public interest entities in the United Kingdom. In October 2007, the MPG published 15 recommendations intended to allow the audit market to work more efficiently and, in the medium-to-long-term, to have a positive impact on audit choice in the UK.

This report provides an update on implementation and an analysis of the responses to the first Progress Report, which was published in May 2008¹.

Developments in the UK

The MPG recommended policies to affect the supply side of the audit market for large firms, in order to make investment by non-Big Four firms in perceived and actual capabilities to audit public interest entities more feasible. MPG recommendations included measures to foster greater transparency in the market; increase the involvement of non-Big Four firms in standard-setting bodies; and improvements in the transfer of information following an audit to a successor auditor.

On the demand side, the MPG recommended that, whilst boards should retain primary responsibility for selecting auditors, if greater choice was to be achieved, the risks for directors of selecting a non-Big-Four firm would need to be reduced, and boards would need to be more accountable to shareholders for their auditor selection decisions.

The MPG also made recommendations which were intended to reduce the risk of a firm leaving the audit market without good reason and reduce the uncertainty and disruption costs in the event of a firm leaving the market.

Progress since the Progress Report published in May includes: the revision of the FRC Guidance on Audit Committees (formerly known as “the Smith Guidance”); the publication of a Exposure Draft by a Working Group established by the ICAEW of the Combined Code style Best Practice Governance Guide for auditors of public interest entities; and the publication of an Exposure Draft by the Consultative Committee of Accountancy Bodies (CCAB) of a draft Voluntary Code of Practice on Disclosure of Audit Profitability.

¹ FRC; “Choice in the UK audit market” May 2008

Significant progress has now been achieved in implementing the majority of the MPG recommendations. The MPG recognised that it would take time for their recommendations to take effect but believed that they would prove to be influential in increasing choice in the audit market in the longer term.

Developments in Europe and the US

Key developments at European level include a European Commission Recommendation that “Member States should take measures to limit liability” for auditors and the publication by the Commission of a consultation on control structures in audit firms and their consequences on the audit market.

In the US, the Advisory Committee on the Auditing Profession has issued its final report to the Department of the Treasury. This report includes recommendations aimed at reducing barriers to the growth of non-Big Four firms and at mitigating potential problems associated with the concentration in the market for auditing services of large firms.

Consultation feedback: Changes to audit firm ownership rules

The first Progress Report sought views on a discussion about the possible impact on audit choice of changes to audit firm ownership rules. Respondents to this generally welcomed the aim of removing barriers to the growth of non Big Four firms. However, some expressed scepticism about the likely effectiveness of changing audit firm ownership rules as a mechanism for encouraging the entry of non Big Four firms into the market for large audits.

In the first Progress Report the FRC noted that even under the current ownership rules there are risks to audit independence and quality but that there are extensive safeguards in place to mitigate these risks.

The FRC notes that there are a variety of views as to whether these risks would be increased significantly if the ownership rules were liberalised and whether the existing safeguards would remain sufficient. The FRC concludes that the adequacy of the existing safeguards would need to be assessed in the light of any specific proposals for liberalisation of the ownership rules.

In light of responses, the FRC continues to recognise that there are certain circumstances where access to ownership capital would be appropriate, but that this gives rise to complex issues: the FRC, therefore, welcomes the European Commission’s consultation on control structures in audit firms and their consequences on the audit market.

Consultation feedback: Use of firms from more than one network

The first Progress Report also sought views on draft Guidance on the use of firms from more than one network. All the respondents express support for the idea of having the Guidance, although four raise concerns about the possible impact on audit quality of using firms from

more than one network, of whom two plus one other, also comment that there would be little use of joint auditors or of auditors from more than one firm in practice. A further three respondents criticise what they considered to be an overly negative tone in the Guidance. In light of this, and to reflect other points made, the draft Guidance has been revised and published in October as an Appendix to the FRC Guidance on Audit Committees.
<http://www.frc.org.uk/corporate/auditcommittees.cfm>

Next steps

Over the next six months it is anticipated that further progress will be made implementing MPG recommendations although most of the responsibility for implementation rests with organisations other than the FRC.

The FRC will continue to monitor the impact of these measures and consider the need for further action. A further progress report will be published in the second quarter of 2009.

One - Introduction and Background

This is the second Progress Report on the implementation of recommendations of the Market Participants Group (MPG).

The implementation of the MPG recommendations forms part of the FRC Audit Market Choice project, which aims to mitigate the risks to confidence in corporate reporting caused by concentration in the audit market for large companies.

The FRC established the MPG, which consisted of investors, companies and audit firms, to provide advice on possible actions that market participants could take to mitigate the risks arising from the characteristics of the market for the audit of public interest entities in the United Kingdom. In October 2007, the MPG published 15 recommendations intended to allow the audit market to work more efficiently and, in the medium-to-long-term, to have a positive impact on audit choice in the UK.

In May 2008, the FRC published "Choice in the UK Audit Market: Progress Report and Consultation" (referred to in this document as "the first Progress Report"). It provided an assessment of implementation to date and consulted on the possible effects on audit choice of changes to audit firm ownership rules, and on draft Guidance on considerations relevant to the use of firms from more than one network.

13 responses to the first Progress Report were received. Responses can be viewed at <http://www.frc.org.uk/about/auditchoice.cfm> Seven responses were from audit firms, three from accountancy bodies and three from other stakeholders. A list of respondents is attached at Appendix 2.

This document contains:

- an update on implementation of MPG recommendations and other developments since the first Progress Report, and;
- an analysis of responses to the points of discussion and on the two specific issues consulted on in the first Progress Report.

Two - Key Developments

Introduction

This section includes a review of relevant developments in the UK (including an analysis of the responses to the first Progress report concerning implementation of the MPG recommendations) and of developments in Europe and the US.

Developments in the UK

Since the first Progress Report there has been further progress in implementing MPG recommendations. This has included:

- The Consultative Committee of Accountancy Bodies (CCAB) published for consultation a draft Voluntary Code of Practice on Disclosure of Audit profitability on 30 September 2008. (<http://www.ccab.org.uk/documents.php>). It is proposed that the Code will become effective for accounting periods beginning on, or after, April 2009;
- The FRC Guidance on Audit Committees (formerly the Smith Guidance) has been revised following consultation and was published in October at <http://www.frc.org.uk/corporate/auditcommittees.cfm>
- The ICAEW has issued a consultation document seeking views on the preparation of a corporate governance code for auditors of public interest entities. (http://www.icaew.com/index.cfm/route/161380/icaew_ga/en/Home/Institute_of_Chartered_Accountants_in_England_and_Wales)

A detailed update on progress in implementing each of the MPG recommendations is attached at Appendix 1.

The MPG recognised that it would take time to implement their recommendations and for these recommendations to have the intended effect.

There is some evidence that non Big Four firms are making greater inroads into the market for the audit of public interest entities. For example, Grant Thornton, in its submission, states that it has improved its leadership position on Aim and increased its market share in FTSE Small Cap and FTSE Fledgling companies from 2.6% to 8.2%.²

² See the submission from Grant Thornton available on our website at www.frc.org.uk. It should be noted, however, that some of this increase is due to their merger with Robson Rhodes. Grant Thornton reports that the number of large public companies in G8 economies audited by member firms of Grant Thornton International grew by 30% in 2007.

Responses to the first Progress Report

General comments

Nine respondents comment on the general progress achieved in implementing MPG recommendations. These include three audit firms, three accountancy bodies and three other stakeholders. Six of the respondents express their support for the progress that had been achieved; two are more sceptical that real progress is being made towards the objectives of the Audit Market Choice project, whilst one opposes the proposition that greater choice is needed in the audit market.

General comments, which were made by respondents, include the following points:

- The implementation of MPG recommendations should take place in the context of a market-driven approach;
- It does not seem to be necessary for the FRC to report on progress every six months;
- The FRC should consider monitoring the award of auditor contracts by FTSE 100 companies;
- Any actions towards increasing choice in the market should only be taken following a full regulatory impact assessment.

Extracts from a selection of comments are set out below:

ICAS supports the work undertaken by the FRC in raising the matter of limited choice in the audit market for listed companies.... Market based measures are more likely to effect robust and lasting improvements than regulatory changes, which may in addition have unintended consequences. Nevertheless, some of the recommendations made by the Market Participants Group should assist market forces, which we have welcomed. (ICAS)

We question whether it is necessary for the FRC to commit itself to making a public report every six months on progress in implementing the MPG recommendations. An annual report may be more sensible, allowing time for changes to be implemented and take effect. (ICAS)

We would strongly encourage the FRC to monitor the impact of its 'Choice in the audit market' project by annually reviewing the number of listed companies changing auditors, segmented into FTSE 100, FTSE 250 and other listed companies, along with the identity of the original and replacement auditors.(Mazars)

In our response to the fifteen MPG recommendations, we challenged the relevance of many toward the objective of increasing choice in the market. Our concerns remain on those points.... We believe fully costed regulatory impact assessments for each specific recommendation or initiative are needed for the effectiveness of progress to be measured. (Ernst and Young)

In general, we believe the work done so far by the FRC and the Market Participants Group to be helpful in furthering the aim of promoting audit choice and quality in the UK market. We continue to believe

issues of choice and quality in the audit market to be inextricably linked.... A greater choice in the audit market is not a sufficient aim in and of itself; rather all efforts that are made should ultimately improve audit quality. (ABI)

The general consensus of members is that there should be greater choice than just the “Big Four” audit firms to audit larger international organisations. The difficulties of audit firms outside this group to enter the market are recognised. It has been suggested that the relaxation of certain rules and the offer of incentives should exist to enable smaller audit firms to offer audit services to larger companies so as to provide a greater field of choice. However, such assistance does have implications which need to be communicated and considered. Any amendments to systems to aid greater choice should not lead to a reduction in the quality, rigour and standards of firms which wish to operate in that arena. (ICSA)

The FRC notes that there is generally continued support for a market-based approach to achieving the aims of the Audit Market Choice project. It will continue to monitor progress on implementing the MPG recommendations, assessing the impact of these recommendations and considering the need for further action.

Specific comments

Comments in relation to individual MPG Recommendations include the following points:

- MPG Recommendation 9 (disclosure of policies relating to the selection of auditors) is not sufficient, as the disclosure is made after the award of the auditing contract and, therefore, does not allow other firms to respond;
- There is disappointment with the pace of the progress achieved so far on the disclosure of financial information in relation to audits;
- There is an urgent need to address the conditions which some intermediary organisations such as investment banks, commercial banks and law firms attach in relation to auditing by Big Four firms;
- The FRC could do more to publicise new auditor liability arrangements;

Extracts from a selection of comments are set out below:

Recommendation 9 requires disclosure after compliance by the company with the imposed restriction on auditor appointment and the benefit of the recommendation is diluted by disclosure of the restriction after an auditor's appointment. There is an urgent need for these intermediary groups to publish their policies on auditor appointments... That would provide the opportunity for excluded audit firms to address concerns directly with the intermediary. Greater transparency of policy would also help to alleviate the current problem of some individuals within those institutions taking unilateral action to influence audit appointments. (Grant Thornton)

Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis. We are disappointed with progress in this area as relevant firms will have the basic accounting data already.

We welcome the work of the FRC in facilitating a debate over choice in the UK audit market and we believe that the developments to date have been useful in stimulating debate and in highlighting some of the risks associated with concentration in the audit market.... Our main concern is that the developments to date do not address the issue of underlying institutional prejudiced that exists within the audit market place characterized by such devices as "Big 4 only" clauses in many financing agreements that act as barriers to entry for firms outside the "Big 4" and which could be addressed for example in Guidance to Boards. (BDO Stoy Hayward)

The perceived advantage to smaller audit firms of limiting liability will remain to be seen, but at least the CA06 provides a mechanism to allow this, which was previously prohibited. With regard to the demand side, greater access to information to incoming auditors and the assessment of the capabilities of different audit firms would hopefully assist boards. The proposal to allow the use of more than one network of auditors to audit individual components of a group, to achieve audit quality for each component and the group as a whole is a compelling one. This could allow expanding companies alternative approaches to using the Big Four firms. It is acknowledged that the responsibility for auditor choice should remain with boards; however, director risk does need to be safeguarded while decision making needs to be transparent. The proposals appear reasonable. (ICSA)

It may be that the FRC could adopt a higher profile in communicating this MPG recommendation in relation to auditor liability as it has application in many jurisdictions. The issue of audit quality has been much to the fore in relation to auditor liability limitation agreements but the related promotion of auditor choice has been much less visible in the UK (no explicit mention in FRC Guidance on auditor liability limitation agreements) than elsewhere, for example in the EC Recommendation of 5 June. (ACCA)

In noting these specific points in relation to individual MPG recommendations the FRC reminds stakeholders that the MPG recommendations were a package of proposals for addressing the aims of the Audit Market Choice project.

Developments at European level

There has been some progress at European level in relation to the liability exposure of audit firms and to possible changes to ownership restrictions on audit firms.

The MPG commented that: "there was general agreement that liability risk can act as a constraint on audit market entry and that it is appropriate for those developing policy in this area to consider the effects on audit choice as well as audit quality."³ In light of this, MPG Recommendation 3 stated that: "In developing and implementing policy on auditor liability

³ Choice in the UK Audit Market: Final Report of the Market Participants Group, October 2007.

arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.”

On 5th June 2008, the European Commission issued a Recommendation concerning the limitation of the Civil Liability of Statutory Auditors and Audit firms.⁴ Article 2 of the Recommendation proposed that liability “should be limited except in cases of intentional breach of duties by the statutory auditor or the audit firm.”

The Recommendation stated that: “Member States should take measures to limit liability” for auditors. It recommended use of one or more of the following methods:

- establishment of a maximum financial amount or of a formula allowing for the calculation of such an amount;
- establishment of a set of principles by virtue of which a statutory auditor or an audit firm is not liable beyond its actual contribution to the loss suffered by a claimant and is accordingly not jointly and severally liable with other wrongdoers;
- provision allowing any company to be audited and the statutory auditor or audit firm to determine a limitation of liability in an agreement.

The Recommendation followed an Impact Assessment by the Commission which considered the options for further harmonisation of liability rules. The Assessment highlights the possible effects of the high exposure of auditing firms to liability claims and the risks such claims may pose in particular to Big Four firms.

The European Commission has recently issued a consultation on control structures in audit firms and their consequences on the audit market.

Developments in the US

The Advisory Committee on the Auditing Profession of the Department of the Treasury was established: “to consider and develop recommendations relating to the sustainability of the auditing profession.” Section VIII of the report focuses on concentration and competition in the auditing market. It issued its Final Report on 6th October 2008.⁵ With regard to audit choice the Report contained a detailed analysis of the audit market for large companies in the US which concluded that the concentration in this market would not be reduced in the near term by smaller auditing firms.

In Section VIII of the report, the Committee recommended that regulators, the auditing profession and other bodies, as applicable effectuate the following:

⁴ C (2008)2774

⁵ Advisory Committee on the Auditing Profession: The Department of the Treasury. Final Report October 6th 2008.

- 1) Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognises that Recommendation 2 (below) will be a higher priority in the near term;
- 2) Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public auditing firms;
- 3) Recommend the Public Company Accounting Oversight Board (PCOAB) in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators;
- 4) Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits;
- 5) Adopt annual shareholder ratification of public company auditors by all public companies;
- 6) Enhance regulatory collaboration and coordination between the PCOAB and its foreign counterparts, consistent with the PCOAB mission of promoting quality audits of public companies in the United States.

The FRC welcomes these developments and recognises the importance of co-ordinated international actions to the achievement of the objectives of the Audit Market Choice project.

Next Steps

Over the next six months it is anticipated that further progress will be made implementing MPG recommendations although most of the responsibility for implementation rests with organisations other than the FRC.

The FRC will continue to monitor the impact of these measures and consider the need for further action. A further progress report will be published in the second quarter of 2009.

Three - Consultation feedback: changes to audit firm ownership rules

Introduction

This section analyses the responses to the discussion on the impact on audit choice of changes to audit firm ownership rules contained in the first Progress Report. 12 respondents commented on this issue. These included seven audit firms, three accountancy bodies and two other stakeholders.

Background

This discussion formed part of the implementation of the MPG recommendation that: “the FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules.” It also followed analysis contained in a study for the European Commission, which concluded that: “restrictions on access to capital represent one of several potential barriers to entry in the market for large audits.”⁶

The FRC sought views on the following statements:

- 1. Changes to the ownership rules could make it easier for existing or new non-Big Four firms to make step-change investments;**
- 2. Any changes need to be considered as part of a package of measures to improve audit choice;**
- 3. The risks that changes to the ownerships rules could lead to *increased* concentration in the market could be outweighed by the potential benefits;**
- 4. There is a risk that financial considerations associated with outside ownership could drive down audit quality but safeguards already exist;**
- 5. There is a risk that outside ownership could lead to a shortage of partners and staff with appropriate skills and personal qualities but this could be mitigated with appropriate policies;**
- 6. Existing company law, regulation and market practice could prevent possible conflicts of interest associated with the firm’s ownership resulting in poorer quality audits.**

⁶ Oxera: “Ownership rules of audit firms and their consequences for audit market concentration” October 2007

General comments

11 respondents provide general comments. These include seven audit firms, two accountancy bodies and two other stakeholders. Of these respondents: two support the general idea of changing audit firm ownership rules; eight are sceptical that this would, by itself, foster entry by non-Big Four firms into the audit market for public interest entities; and one opposes changing audit firm ownership rules. Most respondents feel that it is unlikely that changes in ownership rules, by themselves, will have a significant impact on the behaviour of firms or on the market itself. However, some respondents argue strongly that changes in ownership rules may bring significant benefits, both in relation to the promotion of greater choice and in providing an additional mechanism, through which a failing Big Four company could be rescued.

Extracts from a selection of general comments are set out below:

We believe that it remains appropriate to consider the ownership structures of audit firms and particularly the opportunities for them to raise additional capital.... we believe that the risks associated with changes to ownership rules are outweighed by the potential benefits. (ABI)

We support a relaxation of the restrictions in this area as we consider that they are onerous and unnecessary protectionism. A carefully managed change in the audit firm ownership rules may provide the necessary impetus for smaller firms to develop and compete effectively with the Big Four in the audit market for listed companies. (Deloitte)

It is disappointing that the FRC has elected to produce a paper, with an invitation for comments, on a topic on which the European Commission has signalled that it will be consulting very shortly.... In considering whether a relaxation of these provisions would bring any benefits, one first needs to consider the possible costs, for example, the implementation of a new system to ensure the independence of the auditor and audit firm from audit clients where any investor has an interest; potential reductions to high quality audit; and greater market concentration from the attractiveness of short term financial returns.(PWC)

KPMG has consistently welcomed the opening up of this debate at a UK, EU and indeed global level, since in our view this is increasingly not a national issue. (KPMG)

In the first Progress Report the FRC noted that even under the current ownership rules there are risks to auditor independence and quality but there are extensive safeguards in place to mitigate these risks. The FRC notes that there are a variety of views as to whether these risks would be increased significantly if the ownership rules were liberalised and whether the existing safeguards would remain sufficient. The FRC concludes that the adequacy of the existing safeguards would need to be assessed in the light of specific proposals for liberalisation of the ownership rules.

Comments in relation to the specific statements

1) Changes to the ownership rules could make it easier for existing or new non-Big Four firms to make step-change investments.

Nine respondents comment on this issue. Four responses are from audit firms, three from accountancy bodies and two from other stakeholders. Two of the respondents support the statement, five are sceptical that changes in ownership rules would encourage step-change investments and two oppose the statement.

Key additional points made by respondents, include:

- It would be difficult for firms to raise capital because of the geographical nature of their networks;
- A change in ownership rules may help smaller firms develop and compete;
- Liability claims and insurance could be a problem;
- Ownership is not a barrier to growth of non-Big Four firms but the lack of tendering in the selection of auditors by public interest entities is;
- The changes could make it easier to rescue of one of the Big Four firms if it faced collapse.

Extracts from a selection of these responses are set out below:

We are.... unclear as to how a change in ownership rules could progress the development of new global networks. This is because the significant investment decisions required to achieve this tend to be multi-geographical in scope, which would make capital-raising highly problematic. Similarly, because audit firms have been unable to limit their liability by insurance or other means, any amount of capital raised would be unlikely to protect these networks against large claims. This means, in effect, that firms would have to find investors willing to take a long-term view on a high-risk investment. (Ernst and Young)

We are not, in principle, against further relaxations to the audit firm ownership rules however we remain to be convinced that the current recently modified ones, following implementation of the revised Eighth Directive, are a significant barrier to the much needed extension of choice in the audit market. We also consider it essential that the full consequences of any further liberalisation of the audit ownership rules be considered before any changes are introduced as a number of important aspects do not appear to have been fully considered to date.(Mazars)

Such changes would not necessarily cause an immediate change in the UK market, but any changes would have the benefit that even if no existing audit took advantage of new rules immediately it would allow an existing market participant, which was close to failure or collapse, to potentially be rescued by means of raising external capital.(ABI)

The FRC notes that, on balance, stakeholders expressed some scepticism about whether changes in audit firm ownership rules would foster a step-change in investment.

2) Any changes need to be considered as part of a package of measures to improve audit choice.

Two respondents comment on this issue both expressing agreement with the above statement. One is from an audit firm and the other from another stakeholder.

Extracts from these responses are set out below:

...we do not regard this as a "magic bullet" for increased choice in the market not least because of the significant and sustained investments needed to sustain a high quality global audit practice. Our view remains that limited liability agreements- in the UK- and liability reform more broadly offer greater encouragement in the shorter term to reduce barriers to entry in say the FTSE 100. (KPMG)

It is unlikely that there is one stand alone change that would achieve the majority of desired outcomes. Suggested changes could possibly be advantageous in the long-term but would need to be made in conjunction with other changes. (ICSA)

The FRC notes the support of respondents for the statement that if they are to prove effective in promoting choice in the audit market any measures in relation to changes in audit firm ownership rules need to be part of the wider actions.

3) The risks that changes to the ownerships rules could lead to *increased* concentration in the market could be outweighed by the potential benefits.

One respondent comments on this point, a stakeholder who supports the statement. An extract from this response is included below:

Reducing restrictions to entry will be welcomed by many and would appear to outweigh claimed risks of possible abuse by the existing Big Four companies, in terms of them also taking advantage of the relaxed rules to aid greater investment themselves (ICSA)

The FRC notes that this issue was not generally addressed by respondents suggesting that it may not be a significant concern to them.

4) There is a risk that financial considerations associated with outside ownership could drive down audit quality but safeguards already exist.

Seven respondents comment on this statement. Two responses are from audit firms, three are from accountancy bodies and two from other stakeholders. Five respondents support the

statement that there are risks but that existing safeguards exist, whilst two oppose it, suggesting that current safeguards do not cover the scope of additional risks to audit quality.

Key additional points made by respondents include:

- There are additional risks that firms may be impacted upon by the effects of difficulties experienced by shareholders;
- Quality requirements should be applied to ensure that outside ownership cannot impact upon the independence of audits;
- There is also a risk that perceptions of independence may be compromised;
- Safeguards already exist in relation to financial considerations and these could be applied.

Extracts from a selection of responses are set out below:

We are not wholly persuaded by the latter part of the statement that 'there is a risk that financial considerations associated with outside ownership could drive down audit quality but safeguards already exist'. If an audit firm were listed on the Stock Market, or if it were owned by a company that was listed, its financial position may be substantially impacted by events outside the firm's own control and this could give rise to the perception that if there were significant financial pressures audit quality might not get as much attention as would be deserved. (Mazars)

We... believe that quality requirements should be applied to firm operations to ensure that individual audits cannot be improperly influenced from outside. With these safeguards ownership restrictions would be unnecessary as such. This would liberalise the provision of capital without compromising audit quality. (ICAEW)

Although there might be a risk, the safeguards already in existence are likely to outweigh the risks. Plus, as stated in the consultation analysis, firms with external ownership are likely to have a stronger framework of effective accountability for their actions in order to achieve high quality work than partnerships, in order to protect their investment. It would appear that appropriate mitigating policies would outweigh the risks. (ICSA)

In the first Progress Report the FRC noted that, irrespective of ownership restrictions, there are risks to auditor independence and quality. However, the fundamental damage that would occur if it became even suspected that an audit firm was succumbing to commercial pressure from its non-audit capital providers provides a powerful incentive for those providers to avoid interference in the judgements on individual audits.

In light of responses, the FRC concludes that there do not appear to be significant additional risks from relaxing ownership restrictions, given the safeguards in place, but takes note of the need to monitor the effectiveness of these safeguards should any changes in ownership restrictions be permitted.

5) There is a risk that outside ownership could lead to a shortage of partners and staff with appropriate skills and personal qualities but this could be mitigated with appropriate policies.

Two respondents comment on this statement. They are both audit firms. One respondent suggests that the relaxation of ownership restrictions would not have implications for staffing issues. The other supports the statement that there could be a shortage of partners and staff, but does not conclude as to whether or how appropriate policies may mitigate this effect.

Extracts from these responses are set out below:

We do not consider that the outcome from the Edison Investment Research, that the possibility of taking an equity stake in an employer might support staff retention, provides any support for changing the rules on ownership. As we have previously indicated, there is nothing preventing an audit firm from releasing up to 50% of its management control to external investment (including equity control from staff). We believe that staff retention is based on a number of other unrelated factors, such as firm reputation, personal development and increases in income. (PWC)

We have concerns that if a firm were to grow using external funds then the cost of servicing that capital would reduce the returns available to equity partners and limit the ability to attract and retain partners and staff of sufficient quality consequently limiting growth. (BDO Stoy Hayward)

The FRC notes these responses. The responsibility for recruiting and maintaining high quality staff is the responsibility of individual firms. Those firms considering access to external capital will need to consider the implications on their particular staff and develop policies accordingly.

6) Existing company law, regulation and market practice could prevent possible conflicts of interest associated with the firm's ownership resulting in poorer quality audits.

Three respondents comment on this statement. One is an audit firm, one an accountancy body and the third another stakeholder. Of these, one respondent supports the statement, one opposes it, and the other highlights the possibility of additional measures.

Extracts from these responses are set out below:

Similar issues were raised in the recent proposed changes to the Smith Guidance. If Guidance and ethical standards are brought into line, it would be hoped that such conflicts would be reduced and that companies' boards would have the ability to check and assess audit firms' internal procedures. (ICSA)

We wonder if it has been considered whether, for example, a bank-owned audit firm could have any banking relationships with audit clients of the firm which it owned or whether an institutional investor-owned audit firm could have holdings in audit clients. We presume not in both instances and

this would lead to the number of potential external owners of audit firms being far more limited than anticipated. (Mazars)

Measures could be adopted that distinguish between ownership and control and allow non-auditors to own an audit practice, whilst control of the audit work would remain with the auditors, for example, using non-voting shares or various regulatory measures to prevent interference from the owners. However, we question whether this is realistic and whether many investors would be willing to forego control of their investment. This would also run counter to good corporate governance which encourages shareholder involvement. (ICAS)

In the first Progress Report the FRC noted that even under the current ownership rules there are risks to auditor independence and quality but there are extensive safeguards in place to mitigate these risks. The FRC notes that there are a variety of views as to whether these risks would be increased significantly if the ownership rules were amended and whether the existing safeguards would remain sufficient. The FRC concludes that the adequacy of the existing arrangements would need to be assessed in the light of specific proposals for amending ownership rules.

Next steps

The European Commission has recently published a consultation on this issue and we expect that this will give further impetus to the debate as to the extent to which changes to audit firm ownership rules could contribute to reducing the risks arising from the structure of the market. The FRC welcomes this consultation as a valuable opportunity for stakeholders to consider further this issue and will contribute to this debate.

Four Consultation feedback: draft Guidance on the use of firms from more than one network

Introduction

This section includes a summary of responses to the draft Guidance on the use of firms from more than one network contained in the first Progress Report.

The draft Guidance formed part of the implementation of the MPG recommendation that: “the FRC should provide independent Guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one network.” The MPG intended that the Guidance would provide audit committees of growing companies using non-Big Four firms with relevant factors that they may wish to consider when their activities expand geographically beyond the perceived capacity of their existing firm. More generally, it was expected that the Guidance would also help audit committees to select auditors for individual components of the group consolidated financial statements, based on how best to achieve audit quality for that particular component and for the group as a whole.

The FRC invited comments on the draft Guidance. In particular, it sought views on:

- 1. Whether the Guidance fairly reflects the circumstances in which groups may find it useful to consider each group audit arrangement (firms from a single network, firms from more than one network and joint auditors)?**
- 2. Whether the Guidance fairly reflects the factors that audit committees may wish to consider for each group audit arrangement?**

General comments

13 responses were received. Seven are from audit firms, three from accountancy bodies and three from other stakeholders.

Key points, which are made by respondents, include:

- The draft Guidance is welcomed as a positive contribution;
- It was important that the Guidance is not over-prescriptive;
- The tone of the draft Guidance appears to be too negative and should be neutral;
- There are concerns that the regulatory and market context could make using joint auditors or auditors from more than one network more difficult or costly and that the Guidance will not, by itself, change current practice.

Extracts from a selection of general comments are set out below.

We support the initiative to give Guidance to audit committees on this area. (Grant Thornton)

The FRC draft Guidance makes a positive contribution to this objective...it should also promote increased market efficiency and enable some corporates to reduce their audit costs. (QCA)

...it is essential that Guidance for audit committees is never prescriptive nor suggest a route that committees should take, with the effect that failure to do so will result in criticism at a later date. (PWC)

....the tone of the Guidance as drafted seems to imply that use of more than one network would not normally be appropriate ... The Guidance should be phrased in a more neutral manner. (ICAEW)

There are three main areas that will need concerted action to address over a period of time.

- 1. Regulatory developments. There have been a number of recent regulatory developments that hinder progress towards use of firms from more than one network. For example, the Statutory Audit Directive by making the group auditor solely responsible for the audit opinion: International Standard on Auditing 600 (Revised) generally introduces more impediments. These need to be considered further.*
- 2. The perceptions of audit committees. Ultimately, the decision on which auditor to appoint resides with the audit committee. Audit committees require a degree of security when it comes to selecting their auditor and this results in the larger listed companies opting for Big Four auditors. Whilst a commonly used method in France, the use of joint auditors is not something that the UK market (i.e. audit committees of large listed clients), appears to be content with.*
- 3. Risk of fraud. If there is more than one audit firm auditing a large, complex group then there will be an increased risk that fraud may go undetected as there will be no one person with a view of all the facets of the group. A salient example of this is BCCI, where audit responsibility was spilt between two different firms. (Deloitte)*

In the main, we believe that any move by a company to use a firm from more than one network should be driven by a desire to maintain or increase the quality of the audit... whilst we can see some potential benefits in companies using firms from more than one network, we continue to believe that it will not be a core factor in the long-term goal of increasing audit quality and choice. (ABI)

The proposed Guidance would also appear to be reasonable and any assistance to boards in the execution of their duties is welcomed. However, some may query the resources involved in discharging these duties and also what course of action should boards take if answers and evidence to the

assessment questions be inconclusive or unsatisfactory or, if acceptable, how / whether this should be disclosed. (ICSA)

(We) believe that there are appropriate circumstances when a group could and should use audit firms from more than one network, for example when a different local firm has capabilities more suited to the local market. On the subject of joint auditors we do not believe there would be many circumstances where these arrangements would be cost effective or sustainable for the long term. (BDO Stoy Hayward)

In our view the proposed Guidance for audit committees, on how to make use of firms from different audit networks, would probably have little impact on audit choice. This is because most companies would not, in our opinion, take this course of action. (Ernst and Young)

In light of the balance of comments, which was generally supportive of the draft Guidance, the FRC decided to issue the revised Guidance in October.

Specific comments

1) Whether the Guidance fairly reflects the circumstances in which groups may find it useful to consider each group audit arrangement (firms from a single network, firms from more than one network and joint auditors)?

Three respondents considered this issue directly. All the responses are from accountancy bodies. Two of the respondents support the statement and one opposes it, commenting that the presentation in the draft Guidance appears to be too negative in relation to the use of firms from more than one network.

Key points, which are made by respondents, include:

- The draft Guidance fairly reflects the circumstances in which groups may find it useful to consider each group audit arrangement and the factors that audit committees may wish to consider;
- The draft Guidance appears to have focused on international networks it should also address the possibilities of using small local firms;

Extracts from a selection of responses are set out below:

This draft Guidance is welcome and we consider that, in the main, it fairly reflects the circumstances in which groups may find it useful to consider each group audit arrangement, and also the factors that audit committees may wish to consider for each group arrangement. (ICAS)

The issues addressed in the draft Guidance seem to cover the most likely circumstances for use of various arrangements and the areas suitable for audit committee questioning... The draft Guidance appears to be written to address the concept of potentially using a member or members of another network of firms, on international audits. It should also address the possibilities of using: a) a small local firm that is a single practice, particularly in considering that what may be a small component to the group auditor may be a significant client for the local auditor; b) another firm on a wholly UK audit, for example a company with a divisionalised structure. (ICAEW)

The FRC has updated the draft Guidance in light of these comments to reflect a more neutral tone and also to include additional circumstances where it might be appropriate to use auditors from more than one network.

2) Whether the Guidance fairly reflects the factors that audit committees may wish to consider for each group audit arrangement?

Six respondents comment on this issue directly. These include responses from three audit firms, two accountancy bodies and one other stakeholder. Two respondents include proposed text for re-drafting of the draft Guidance. Key points made by respondents, include:

- There are issues in relation to shared responsibility and liability;
- There is a need to identify the lead auditor and this auditor should have the capability and experience to take an overall view of the group audit;
- There may be issues of concern in relation to different internal cultures and working methods;
- The auditor also needs to have a close understanding of the business;
- It is important that any Guidance does not become a “tick box” exercise for audit committees;
- The Guidance is negatively worded and appears to have a “bias” against the use of firms from more than one network.

Extracts from a selection of responses are set out below:

Our comments in relation to this Guidance are that the risks to audit quality that could arise if firms from more than one network are used..... relate primarily to the allocation and acceptance of shared responsibilities. These include:

- *The need to identify responsibility for the various parts of the overall audit with the potential problem of some aspects not being covered, or being covered by both network firm;*
- *The need to identify the lead auditor, and his willingness to rely on another auditor, who is not part of the same network, may lead to responsibility, quality and liability issue;*

- *A question of whether the lead auditor has the capability and experience to take an overall view of the group audit where the audit has been undertaken by firms from different networks;*
- *There may be different internal rules/culture on independence, conflicts of interest etc (ICAS)*

As regards the matters for the audit committee to consider in relation to joint auditors and the relationship with management, it may be helpful to add a couple of further considerations:

The Guidance focuses on keeping auditors and management at a distance and maintaining the separation of the auditor. However it should recognize that there is always the need for the auditor to be close enough to have a sound understanding of the client to be able to form a sound quality audit opinion and challenge management's view;

The comments on 'divide and conquer' could also address the importance of not undermining the robustness of the auditors view. In a joint audit, there may be a certain amount of competition between the joint auditors, particularly if management have indicated that they are considering moving to a single auditor. This may allow management to "opinion shop" between the two firms and apply additional pressure on both auditors to support management's view when in another circumstance an alternative treatment may be more appropriate. (ICAEW)

We believe that audit committees are already making decisions on the practicality and cost of using firms from more than one network in the production of a high quality audit as part of their wider deliberations on the appointment of an auditor. We suggest that Guidance should only aid that process rather than force audit committees to approach decisions as a 'tick box' exercise; (PWC)

We are broadly supportive of the draft Guidance but are concerned that the current wording shows some bias against the use of firms from more than one network on an audit and against the use of joint auditors... (Mazars)

These appear to be suitable aspects for any audit committee to consider. The crucial point will be how well the questions are answered and illustrated by the audit firms in question and what the audit committee should do if a satisfactory answer is not forthcoming. Other considerations are that such processes could be time consuming and costly and, once undertaken, what should be done with the results? How much should/ needs to be released to shareholder? (ICSA)

The FRC has updated the draft Guidance to provide further clarity on some of the factors that audit committees might consider. The revised Guidance is now included in the FRC Guidance on Audit Committees, which was published in October at <http://www.frc.org.uk/corporate/auditcommittees.cfm>

Appendix 1 - Progress on MPG Recommendations

MPG recommendation and objective	Implementation arrangement	Implementation progress	Expected timing of next steps
<p>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.</p>	<p>FRC to prepare and consult on a discussion paper on the possible effects on audit choice of changes to audit firm ownership rules.</p> <p>FRC to use discussion paper to influence legislative change in the EU and US.</p> <p>European Commission to publish Consultation on changes to ownership restrictions.</p>	<p>Completed in Q2 2008 in first Progress Report.</p> <p>Ongoing.</p> <p>The European Commission has recently issued its consultation on control structures in audit firms and their consequences for the audit market.</p>	<p>Responses are to be made to the Commission consultation by 28 February 2008</p>
<p>2. Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.</p>	<p>Guidance for the Voluntary Disclosure of financial results to be prepared.</p> <p>Firms to start reporting on a voluntary basis.</p>	<p>Draft Guidance for the Voluntary Disclosure developed by the CCAB and published as an Exposure Draft on 30 September 2008.</p>	<p>Comments to the Exposure draft are required by end 2008.</p> <p>To be used by firms for accounting periods from 1 April 2009.</p>
<p>3. In developing and implementing policy in auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.</p>	<p>FRC to send recommendation to the working group preparing Guidance on auditor limitation agreements, the European Commission, the US Treasury and relevant authorities.</p>	<p>Under Section 534 to 538 of the Companies Act 2006, which came into force on 6 April 2008, auditors will be able to negotiate with companies whose accounts they are auditing to limit liability by contract to an amount that is "fair and reasonable in all circumstances."</p>	<p>FRC to monitor take-up of LLAs and how things evolve across the EU and US during 2009/10.</p>

MPG recommendation and objective	Implementation arrangement	Implementation progress	Expected timing of next steps
	Further consideration of policy in the EU and US.	<p>The FRC established an independent working group to produce guidance to directors on the use of agreements to limit the liability of auditors of companies. The working group was chaired by Sir Anthony Colman, and included representatives of companies, investors and the accountancy profession. The final Guidance was published in June 2008.</p> <p>On June 5 2008, European Commission issued a Recommendation to Member States asking them to limit auditor liability, other than in cases involving wilful misconduct by auditors.</p>	
4. Regulatory organisations should encourage participation on standard setting bodies and committee by appropriate individuals from different sizes of audit firms.	<p>FRC to review policies on membership of their boards and committees.</p> <p>FRC to send recommendation to International Auditing and Assurance Standards Board, and member bodies of the Consultative Committee of Accountancy Bodies.</p>	<p>The new FRC Board that came into being on 1 November 2007 has undertaken to comply with the relevant principles and provisions of the Combined Code.</p> <p>The Code provisions include the need for the nomination committee to evaluate the balance of skills, knowledge and experience of a board when considering the appointment of new directors.</p> <p>In its call for nominations for IFAC Boards and Committees in 2009, issued in February the</p>	Non- Big-Four firms to put forward candidates for standard-setting bodies and committees.

MPG recommendation and objective	Implementation arrangement	Implementation progress	Expected timing of next steps
		International Federation of Accountants has included tables setting out the professional diversity of each of its Boards and Committees, including the IAASB. Nominating organisations are encouraged to consider how their candidates would strengthen the professional diversity of the relevant board or committee.	
5. The FRC should continue in its efforts to promote understanding of audit quality and should promote greater transparency by the firms and the FRC of the capabilities of individual audit firms.	<p>The FRC to finalise its paper setting out the drivers of audit quality. Firms report publicly on their capabilities in line with the drivers of audit quality.</p> <p>The Audit Inspection Unit will monitor and report publicly on firms' capabilities in line with regard to the drivers of audit quality.</p>	<p>In April 2008 the POB published regulations requiring auditors of public interest entities to publish annual transparency reports and setting the minimum requirements such reports must meet. The POB encourages firms to differentiate themselves, for example by reference to the Audit Quality Framework. The POB will monitor the way in which the firms meet their obligations under the new arrangements.</p>	<p>The POB will review the firms transparency reports during 2010. The FRC plans to update the audit quality framework in 2010.</p>
6. The auditing profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.	The Joint Audit Committee (JAC) of ICAEW, ICAS and ICAI is in the process of developing Guidance for their members to allow successor auditors access to all relevant information held by their predecessor in respect of the last audit report signed by the predecessor.	New audit regulations and Guidance have been published by the Joint Audit Committee of the ICAEW, ICAI and ICAS for mechanisms to allow access by the incoming auditor to working papers of the predecessor auditor.	Firms start to follow new arrangements. Audit Inspection Unit considers effectiveness of new arrangements.

MPG recommendation and objective	Implementation arrangement	Implementation progress	Expected timing of next steps
7. The FRC should provide independent Guidance on Audit Committees and other market participants on considerations relevant to use of firms from more than one audit network.	FRC prepare independent Guidance on Audit Committees in draft. FRC to publish and distribute final version of the Guidance.	Included for consultation in draft in the first Progress report. Final version is attached in Appendix to the FRC Guidance on Audit Committees – published October 2008.	Action completed.
8. The FRC should amend the section of the FRC Guidance on Audit Committees dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection process.	The FRC will prepare revised Guidance on Audit Committees.	Issued for consultation March 2008. Final FRC Guidance on Audit Committees published in October 2008	Action completed.
9. When explaining auditor selection decision, Boards should disclose any contractual obligations to appoint certain types of auditing firms.	Included in the FRC Guidance on Audit Committees.	Issued for consultation March 2008 Included in the FRC Guidance on Audit Committees.	Action completed
10. Investor groups, corporate representatives, firms and the FRC should promote good practices for shareholder engagement on auditor appointment and re-appointments.	Investor groups consider information published by companies through recommendation 8 and firms through recommendations 2, 5 and 14. Investor groups consider need for any revision to existing Guidance on shareholder engagement on auditor selection in light of availability of improved information described above.	The NAPF's Corporate Governance Policy and Voting Guidelines published in November 2007 encourage companies to consider submitting the audit function to periodic tender and disclose their policy on this matter, including when the audit was last subject to tender. The Guidelines also encourage improved disclosure on the auditor re-selection decision and disclosure of any	Action completed.

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		contractual obligations to appoint audit firms.	
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.	<p>The Auditing Practices Board is reviewing the ethical standards. Whilst the focus is on achieving high standards of auditing, the APB will consider the proportionality of standards. In doing so it will have regard to the views raised in this debate on particular ethical standards.</p> <p>FRC to send recommendation to the International Ethics Standards Board for Accountants and SEC.</p>	<p>APB published revisions to the ethical standards in April 2008. It reported that during its review of the standards it considered changes to the rotation periods for partners involved in listed company audits, including the possible effects of such a change on audit choice. It concluded that there is insufficient consensus to make a change to the current five year requirement at this time.</p> <p>Report sent.</p>	Action completed.
12. The FRC should review the Independence section of the FRC Guidance on Audit Committees to ensure that it is consistent with the relevant ethical standards for auditors.	The FRC will prepare revised Guidance on Audit Committees	<p>Issued for in consultation March 2008.</p> <p>Revised Guidance included in the FRC Guidance on Audit Committees published in October 2008.</p>	Action completed.
13. Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.	<p>FRC and its operating bodies to review policies on regulatory penalties and publish for discussion outline details of any proposed changes.</p> <p>The FRC will also raise the matter with its regulatory counterparts in other major jurisdictions.</p>		

MPG recommendation and objective	Implementation arrangement	Implementation progress	Expected timing of next steps
14. Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.	The ICAEW to form a working group to develop a Combined Code-style best practice corporate governance guide for auditors of public interest entities.	The ICAEW has established a working group chaired by Norman Murray, Chairman of Cairn Energy Plc that will develop a code of best practice governance for accountancy firms that audit public interest entities. This is likely to be published for consultation at the end of October 2008.	Consultation responses to be made by 31 January 2009.
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.	The FRC will prepare revised Guidance on Audit Committees.	Issued for consultation in March 2008. Revised Guidance included in the FRC Guidance on Audit Committees.	Firms to consider contingency arrangements.

Appendix 2 - List of respondents to the consultation

The consultation took place between May and August 2008.

Respondents included:

The ACCA

The Association of British Insurers

BDO Stoy Hayward LLP

Deloitte and Touch LLP

Ernst and Young LLP

Grant Thornton Ltd

The Institute of Chartered Accountants in England and Wales

The Institute of Chartered Accountants of Scotland

The Institute of Chartered Secretaries and Administrators

KPMG LLP

Mazars LLP

Price Waterhouse Coopers LLP

The Quoted Companies Alliance

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