



RESPONSE TO GREEN PAPER

"AUDIT POLICY: LESSONS FROM THE CRISIS"

**FINANCIAL REPORTING COUNCIL
DECEMBER 2010**

AUDIT POLICY: LESSONS FROM THE CRISIS

1. Introduction and main points

1.1 The Financial Reporting Council (FRC) welcomes the opportunity to respond to the Commission's Green Paper on *Audit policy: Lessons from the crisis*. We believe that the paper covers the most important aspects of audit policy and regulation and we hope that it will provide for an effective debate on the issues.

1.2 The FRC is the United Kingdom's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC and its operating bodies have a number of responsibilities in relation to audit, including policy, standards, monitoring and investigations. These functions are carried out with the primary goal of improving audit quality. The FRC will shortly publish a discussion paper on possible improvements to corporate reporting, audit and the audit report.

1.3 We would stress that our overarching objective is to preserve and enhance audit quality. This in turn enables investors to make sound judgments and supports efficient capital markets. Any changes to the role of the auditor, the structure of the audit market and/or the regulatory framework should be made only if it is clear that they will not adversely affect audit quality.

1.4 Audit quality is difficult to define. An auditor's opinion as to whether the financial statements are "true and fair" is subjective and there are differing views on the extent and nature of audit evidence required to support an audit opinion. Limited transparency makes an assessment of audit quality by those who rely on it difficult as the audit report provides limited information to assess the underlying quality of audit and users have a limited role in appointing the auditor. To help address this, the FRC has identified a number of key drivers of audit quality and has published guidance¹ to assist audit committees and other stakeholders in assessing the quality of an audit or audit firm.

1.5 The paper asks a large number of detailed questions, which are addressed in Appendix A. In this main submission we concentrate on three main themes as follows:

- Concentration and market structure
- The role and value of audit
- Audit regulation and supervision

1.6 As a result of the Green Paper the FRC would like to see:

¹ 'The Audit Quality Framework', FRC, 2008

- A clear strategy to address the key questions raised and agreement on the appropriate way forward;
- A proportionate regulatory framework to address the market impact of a failure of one of the major audit firms;
- Proposals to deal with the level of audit market concentration so as to increase choice and address the moral hazard implicit in the previous bullet;
- Improved engagement between audit committees and investors on audit related issues;
- Effective international co-operation between regulators on audit quality issues; and
- An audit market which stimulates innovation and where firms compete on quality.

1.7 With respect to the key proposals within the Green Paper, the FRC supports:

- Efforts to minimise the systemic risk associated with the level of audit market concentration provided that those efforts are not at the expense of audit quality. We believe that these efforts should include:
 - The development of contingency plans under the auspices of the Financial Stability Board;
 - Subject to minimum regulatory requirements, greater innovation in the audit product, making audit tenders more attractive; and
 - Improved engagement between audit committees and investors on audit-related issues.
- Improved transparency of the audit process. The primary vehicle for greater transparency should be the audit committee report with a requirement for the auditors to report positively on its completeness and fairness.
- The adoption of ISAs in Europe. We suggest that the proposed European Audit Authority should be responsible for the endorsement process.
- The tightening of auditor independence rules. The UK has recently consulted on this issue and found support from market participants for clearer and more transparent rules, although not for a complete ban on the provision of non-audit services by auditors to their clients. The revised UK Ethical Standards may be a good starting point for discussion on this topic.
- The establishment of a European Audit Authority to ensure that audit receives appropriate focus within the European regulatory architecture.
- In principle, measures to increase the flexibility for firms to operate within different member states. However any move to “maximum harmonisation” should not be at the expense of existing standards.

1.8 We do not support:

- A wholesale ban on the provision of non-audit services to audit clients. As noted above, the UK’s recent consultation on this issue indicated that investors and other market participants are not in favour of such a ban. We would also be concerned

that a ban which included audit-related services could stifle the development of more innovative audit products.

- The forcible creation of audit-only firms. Such firms would be unable to offer their staff a wide range of work experiences and compensation packages are likely to be lower than firms can offer currently, making it more difficult to recruit and retain high quality personnel and hence impacting negatively on audit quality.
- The mandatory use of joint audits. There is a risk that some matters fail to be addressed effectively as they are seen to fall between the two firms. Client management may also engage in arbitrage between the two firms, particularly when it comes to difficult or contentious judgements.

2. Concentration and market structure

2.1 The market for the audits of the largest companies in the UK is, as in most member states, highly concentrated. The “Big Four²” audit 99% of the FTSE 100 and 95% of the FTSE 250.

2.2 We believe that the degree of concentration represents a systemic risk³ to capital markets. In particular, we are concerned at the potential impact on market stability and investor confidence if one or more of the “Big Four” was to fail or otherwise to exit the market.

2.3 The immediate impact of such an event would be significant. Public and investor confidence in the financial statements of the failed firm’s clients would be undermined and equity, bond and lending markets would fall significantly as a result. In the short term, some of the failed firm’s former clients may find themselves unable to issue audited financial statements in a timely manner or potentially to find an appropriate replacement auditor.

2.4 In the longer term, existing problems around lack of choice would be exacerbated. Additionally, if the event were audit-related, the remaining firms may become reluctant to audit companies in high risk industries and may even begin to withdraw from certain sectors of the market. At a minimum, a market with three or fewer large firms capable of auditing the largest and most complex clients is likely to require a significantly more intrusive regulatory environment and therefore cost.

2.5 The Big Four are organised as national or regional firms, but are all members of international networks. The collapse of any national or regional firm, particularly one in a

² The “Big Four” audit firms are Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.

³ References to “systemic risk” refer to the impact on capital markets due to a lack of confidence in audit or a particular auditor which we believe would arise from failure of one or more Big Four firm

large or litigious territory, could quickly spread contagion through the network and lead to global failure. Indeed, this was what happened with Arthur Andersen. Any contingency plans therefore will need to be internationally coordinated and we believe that this should be included with the Financial Stability Board's agenda.

2.6 Contingency plans should be developed that, as a minimum, seek to:

- Reduce the risk of a firm leaving the market without good reason
- Reduce uncertainty and disruption in the event of a firm leaving the market
- Ensure that, in the event of a firm failure, the future audit market is not dominated by three or fewer firms.

2.7 In order to accomplish these objectives, the contingency plan will need to include:

- A mechanism whereby firms inform regulators of any emerging issues which could threaten a national firm and/or its network;
- Arrangements aimed at stabilising the firm and preventing immediate collapse through the exodus of clients and staff while an investigation is carried out.
- An objective incident assessment to understand the root cause of the incident, whether the issue is systemic to the firm and/or network and whether the firm in part or in whole is worth saving. The assessment should be independent of any subsequent regulatory or disciplinary action.
- A response plan, which would include a decision on whether the relevant regulator(s) felt able to provide continued support to the firm and on what terms. If continued support was considered inappropriate, or if it was clear that the firm would not survive because of the actions of clients and other market participants, then the plan would need to include provision for an orderly transition of clients and staff to one or more other firms.

2.8 The focus should not, however, be on contingency planning alone and nor should regulators seek to preserve the Big Four at any cost. There is a moral hazard problem if firms believe they are "too big to fail" and act on the basis that governments and regulators will not take action which could result in a firm leaving the market.

2.9 The FRC believes that the best solution to systemic risk in the market and the moral hazard arising from it is to reduce the level of concentration by increasing choice in the audit market.

2.10 The Green Paper includes a number of suggested actions to reduce concentration in the market and we explore these in more detail in Appendix A. We would note that many of these have been debated extensively in the UK as part of the FRC's Audit Choice project.

2.11 The Commission will be familiar with the work of the FRC on this project. We have concluded from our work so far that market-based solutions have not been effective and that there is a need for regulatory intervention of some sort. We would note that the issues of concentration and choice in the market cannot be dealt with solely by audit regulators and we would welcome the involvement of competition authorities in the EU and internationally.

2.12 The FRC would suggest the Commission consider the following proposals to reduce concentration and increase choice in the audit market:

- Encourage banks and other systemic institutions to use non-Big Four firms as a source of advice to their risk committees. This would give such firms an exposure to large companies they might not otherwise have access to and may in time provide them with the opportunity to tender for the audits of some of these entities;
- Give serious consideration to amending the current rules on audit firm ownership, allowing audit firms to access external capital to fund expansion; and
- A prohibition the use of “Big Four only” clauses in banking and loan covenants.

2.13 The Green Paper includes a number of other regulatory proposals to address the situation, one of which is mandatory rotation. The advantages of this include the introduction of a fresh approach to the conduct of an audit and the key judgements involved. It may also be an appropriate way to address concerns that auditors become too close to the company they audit and its management through a natural desire to retain the audit. Disadvantages include the risk of audit failure during and shortly after the transition as the new auditor becomes adequately knowledgeable of the company and its business and the difficulty of ensuring auditor independence (as an incoming audit firm may have provided non-audit services to the company concerned). There may also be commercial considerations arising from audit firms being appointed to audit companies that compete or which are in the midst of a major transaction or restructuring, and whether firms will have the necessary expertise in all relevant jurisdictions to undertake a quality audit. This approach would cause major disruption to the company; whilst there would be limited incentive for the auditors to do more than the minimum as they would not have the incentive of reappointment.

2.14 An alternative to mandatory rotation would be the mandatory retendering of audits so that companies could be required either to put the audit out to tender on a periodic basis (say every 10 years) and then report to shareholders on the reasons for the audit appointment made following such re-tendering process. This option has the practical difficulty that there will a number of major companies for which this will not be a practical option – because other firms will not be independent (or able to become independent) or will be inappropriate because they are actively engaged for key competitors.

2.15 Another option would be greater shareholder involvement, with audit committees required either to:

- Report on the process by which they reached their recommendation to appoint or re-appointment (as the case may be) the company's external auditors and the reasons for their recommendation; or
- Discuss with a number of principal investors the approach to be taken to the appointment or re-appointment of its auditors, including the merits or otherwise of putting its audit out to tender and then report on that consultation to shareholders generally.

The FRC recognises the practical difficulties involved in mandatory rotation and re-tendering. It believes that this last proposal would be appropriate, particularly given the increased focus on the stewardship responsibilities of shareholders.

2.16 Similarly, we would not favour the mandatory use of joint auditors or audit consortia. We believe that such a requirement may drive up costs and potentially could have a negative effect on audit quality; for example if neither firm take responsibility for difficult contentious judgements, or if management engage in opinion shopping between the two firms.

2.17 So far we have commented on the impact of a firm leaving the market and our belief that a market with three or fewer firms would be unsustainable. However, we also have concerns about the effect of the current market structure on market practices.

2.18 Market theory would suggest that a market with four major participants would see participants competing against each other on price, quality and innovation.

2.19 Some research⁴ indicates that increased concentration has led to higher audit fees. However this is not universally agreed and it is true that in the event of a competitive tender, audit firms often compete fiercely on price. However, tenders are relatively rare.

2.20 Whilst the position on pricing remains unclear, there is evidence of a lack of innovation in audit. In most markets participants seeking to increase market share seek to develop new and improved product offerings to be more attractive to prospective clients. This has not happened in the audit market to any significant extent, with all of the major audit firms applying similar methodologies to produce a virtually identical offering. The prescriptive format of the audit report itself and regulation generally offer only a partial explanation for this absence of innovation. This is explored further in the next section.

⁴ 'Competition & choice in the UK audit market', Oxera, 2006

3. Role of the auditor

3.1 Currently, the primary purpose of an audit is to provide independent assurance to shareholders that the directors have prepared the financial statements properly. An audit does not exist to provide general comment or opinion on a company's business model, although auditors are expected to consider the risks facing the company, market conditions and the availability of finance when assessing the going concern principle.

3.2 There is evidence of an expectation gap between the actual scope of an audit and public perception of the information an audit should reveal. Indeed there is evidence of such a gap within the Green Paper itself which suggests that auditors provide an independent opinion on the financial health of a company as opposed to an opinion on whether their accounts show a "true and fair" view. This particular expectation gap was evident in commentary following the financial crisis, with many people querying how a bank could have received an unqualified audit report, only to collapse a few months later. Specifically, it was questioned whether the risks and uncertainties facing the banks were adequately described and/or it was correct for the financial statements to be prepared on a going concern basis. In this context it is important to appreciate that a conclusion, based on reasonable assumptions about the company and the markets in which it operates, to prepare a company's financial statements on a going concern basis is not the same as reaching a definitive conclusion that the company will in fact be a going concern some 12 to 15 months later.

3.3 Some of the criticism of the role of audit in the crisis appeared not to be a criticism of audit, but a criticism of the requirements of international accounting standards. Our response does not address this particular issue as it has been subject to extensive study and discussion on other occasions, and these discussions have led to certain standards being amended.

3.4 In considering the role of audit in the financial crisis, the critical point is that audit, in common with prudential regulators and governance arrangements more generally, did not give a sufficiently early warning. However, we recognise that no system can be foolproof when it comes to highly significant low probability, high impact events.

3.5 We believe that improvements can be made to accounting and audit so there is earlier warning of emerging issues while there is still time to take remedial action. Such changes would contribute to more effective governance but we do not claim that they would have prevented the collapse of the credit markets. That would only have been achieved if action had been taken by prudential regulators and others as well as by

auditors. Several gatekeepers failed. All need to raise their game and we believe our proposals as set out in this paper and our related discussion paper⁵ help to achieve this.

3.6 Within a framework of minimum standards set by regulation, a competitive market would expect to see firms offering alternative audit products to close the expectation gap and gain market share. This might include assurance on a wider range of matters or greater transparency of existing work. This may be partly explained by the lack of engagement between the audited entity, the auditor and investors on audit related issues.

3.7 In the absence of market-based advances in the audit product it is necessary for regulators and legislators to provide leadership. Proposals to extend the role of auditors fall into three categories:

- (i) Improved transparency of the audit;
- (ii) Extension of the scope of the audit; and
- (iii) Extension of the stakeholders to whom the auditor reports.

3.8 We believe that there is a case for providing greater transparency about the work and findings of the audit. This is particularly important in view of the changing issues facing auditors, in particular the increasing size and complexity of business, globalisation, the role of technology and the increased importance of professional judgement since the adoption of IFRS and the increased emphasis on fair value accounting.

3.9 The areas where professional judgement is critical to the effectiveness of a particular audit include:

- The auditor's initial assessment of the risks of a company's financial statements being vulnerable to misstatement;
- Levels of materiality;
- The auditor's views on the quality and effectiveness of the company's accounting policies, systems and internal controls;
- The reasonableness and transparency of management's approach to estimates and valuations;
- The quality of management's disclosures in the Annual Report;
- The approach taken by management to issues raised by the auditors in the course of the audit;
- The auditor's assessment of the sufficiency of the audit evidence;
- The extent to which reaching the audit opinion has involved issues with a high degree of uncertainty; and
- The meaning of "reasonable assurance" in the context of that specific audit.

⁵ 'Effective company stewardship', to be published shortly

3.10 It has been suggested that auditors could be given extended responsibilities in respect of the provision of this information. However, it is a fundamental tenet of company law that a company's management, not its auditors, are responsible for the management of that company, including the use to which its assets are put, the liabilities that it incurs and effectiveness of its internal controls. For that reason we believe that the responsibility for increasing the transparency of the audit should rest with the company and that the most appropriate way to transmit it to investors is via the report of the audit committee. We believe that the auditor should then be required to make a positive statement on the completeness and fairness of the audit committee report or provide additional information where the auditor considers it necessary.

3.11 We also believe there is scope for increasing the volume and nature of information contained in Annual Reports which is subject to some form of assurance. Audit Committees, in discussion with investors, should determine which, if any, aspects of this information would be more useful to investors if subject to additional assurance at proportionate cost. Auditors or others with appropriate skills could then report on this separately to the statutory audit opinion. Examples might include key performance indicators, the company's business model identification and management of risk.

3.12 The Green Paper asks specifically about communication between financial regulators and the auditors of investment firms and similar systemic institutions. In the UK auditors of financial institutions are already required to report to regulators matters of serious concern. However, we believe that auditors can contribute further to the effective regulation of such institutions by more frequent reporting. The FRC, together with the UK's Financial Services Authority, has recently published a paper on the contribution the auditor can make to prudential regulation, including an increase in statutory and voluntary reports to the relevant regulator.

3.13 Reporting by auditors to regulators is an important safeguard in the prudential regulation of financial institutions. We would be cautious, however, about proposals to widen auditors' responsibilities to a wider group of stakeholders such as employees or creditors. We believe it is right that the primary responsibility of auditors is to shareholders. Employees, creditors and others doing business with the audited entity do of course have an interest in the effective audit of financial statements and are likely to feel greater confidence in their dealings with the entity if they are satisfied that the audited accounts provide a true and fair view of the entity's financial position.

3.14 It would be wrong to limit the debate on the role and effectiveness of audit to the audit firms themselves. Investors have a responsibility to ensure that the companies they own are managed effectively. If investors are unhappy with the performance of the auditors; have concerns about their closeness to management; or believe that audit

committees are not challenging management effectively; they should voice those concerns. In broad terms we would support measures which increase shareholder engagement in audit quality, including the appointment, re-appointment and removal of auditors.

4. Audit regulation and supervision

4.1 Although the majority of audit work is carried out within national boundaries, the largest public interest entities operate in many different jurisdictions. As noted above, the Big Four (together with other large audit firms) also operate on a global basis and have in some cases developed regional structures.

4.2 This increased globalisation has been recognised to some extent by standard setters, with the introduction of international accounting, auditing and ethical standards, albeit with some national variations.

4.3 We support the adoption of the clarity ISAs in the EU, which we consider an important element of strengthening the European framework for the performance and oversight of statutory audits. We believe that ISAs should be adopted for the audits of all companies which require a statutory audit.

4.4 On the question of whether ISAs should be made legally binding within the EU, we would caution against including large amounts of application material in national laws. One option would be to enshrine the objectives and requirements of the ISAs into legislation, but deal with their application via a Recommendation. If a new Supervisory Authority was to be set up (see below) then that body could also take responsibility for the ISA endorsement process.

4.5 Whatever mechanism is used to encourage the adoption of ISAs we would stress the importance of allowing limited national “add ons” where they are necessary to meet specific national legal requirements relating to the scope of statutory audits.

4.6 The paper raises the question of auditor independence and questions whether an EU-wide prohibition on the provision of non-audit services to audit clients should be introduced.

4.7 We agree that some tightening of the rules governing the provision of non-audit services to audit clients is appropriate. The FRC has recently consulted extensively on the question and we have updated the UK Ethical Standards as a result. UK independence requirements (as set out in the Ethical Standards) are now considerably more restrictive than IFAC rules and impose additional obligations on audit committees with regard to transparency. These revised Ethical Standards may serve as a starting point for discussion on this topic.

4.8 We would not, however, be in favour of a blanket ban on the provision of all non-audit services to audit clients. It is clear from the responses we received to our consultation that there is no support from any group of stakeholders for such a prohibition and that investors were generally hostile to the idea. We would add that there is no evidence that the provision of non-audit services by auditors was a factor in the financial crisis.

4.9 The paper also raises the possibility of the forcible creation of audit-only firms. We believe that this could undermine audit quality. We would note that less than half of most large audit firms' revenue is from audit itself, and, as audit thresholds have risen, some smaller firms now maintain a very small audit practice. Given the choice of continuing as a "pure" audit firm or a provider of a broader range of professional services, many firms of all sizes may on commercial grounds choose the latter, reducing competition and choice. Additionally, a "pure" audit firm would be unable to offer its personnel a wide range of different work experiences. A combination of lower reward and fewer career prospects is likely to make it more difficult for firms to attract and retain high quality staff. Audit quality may suffer as a result.

4.10 We mentioned earlier the lack of innovation which characterises the audit market. If we are to see greater innovation and added value then at a minimum firms must be allowed to provide audit-related services which could complement the assurance to investors on the financial statements.

4.11 For these reasons we would not support a complete ban on non-audit services. However, we recognise the importance of auditor independence and would support greater transparency in corporate reports around the services that the auditor has provided during the year.

4.12 The supervision of auditors has, to some extent, lagged behind the internationalisation of audit, with national regulators focusing their regulatory activity on national firms, with limited regulatory effort on assessing the impact of regional and global structures on domestic audit quality. Therefore we would support enhanced arrangements for cooperation between national regulators. In particular, there is a need for a global accord/protocol between regulators in the EU and other major markets on how regulatory/disciplinary action against the largest audit firms should be co-ordinated.

4.13 In principle we would support the creation a European Supervisory Authority for audit matters. Audit is important to the work of the other authorities currently being established and so without a dedicated audit authority there is a risk that it will be considered a peripheral activity within each. Such a split would lead to a lack of focus and risks sub-optimal or partial solutions to audit-related matters. This would be inappropriate given the importance of audit to capital markets, banking and insurance supervisors.

4.14 The precise functions of the Authority must be clear. We would envisage that these functions would include:

- Enhanced supervision of aspects of firms' regional structures which affect audit quality in national markets;
- Ensuring an appropriate focus on audit within the European regulatory architecture for securities, banking and insurance;
- Facilitating effective co-operation between national audit regulators; and
- The adoption of ISAs.

As noted above, the majority of audit work is carried out within national boundaries. National regulators should therefore retain oversight and monitoring responsibilities for audits carried out within their respective markets.

4.15 Given the importance of audit to investors, the Authority should work closely with the European Securities and Markets Authority.

4.16 Greater harmonisation between European countries in respect of qualifications and licensing should also be explored further. We would separate this into matters affecting individuals and those applying primarily to firms.

4.17 With respect to individuals, we would note that an auditor who has qualified in one member state may practise in another, subject to an aptitude test on national law and regulation. For as long as there are significant differences in national laws and regulations, we do not see how further harmonisation, or the abolition of the aptitude test, would be possible. We would be reluctant to move to a single European audit qualification. The accountancy professions in different member states have important historical and cultural differences and undermining national practices would in some cases be to the detriment of audit quality. For example, the UK has found that maintaining opportunities for graduates from all disciplines, as well as suitably qualified non-graduates, to enter the profession has had a positive effect on the recruitment of high quality staff and in turn on audit quality. We are aware of work undertaken by professional bodies in a number of member states in the area of common content of professional examinations, and suggest that any proposals in this area should be cognisant of this work.

4.18 The Green Paper does not mention the accountancy professional bodies, but we would note that these bodies have an important role to play in enhancing audit quality by encouraging their members to act according to their professional ethics. Regulators should work with professional bodies to ensure that they fulfil this role and do not restrict their activities to lobbying for their members' commercial interests.

4.19 On greater harmonisation of the regulation of firms, we would need to see the detail of what is proposed. One specific suggestion in the Green Paper is for an “audit passport” which would enable firms to operate across the European Union. In principle we have no objection to this, subject to the overriding need to preserve audit quality. Careful consideration would have to be given to the practicalities of licensing and monitoring firms which may be constituted in one member state but carry out audits in another.

4.20 In general we would have concerns about the proposal for “maximum harmonisation”. As well as the differences in the content of the audit qualification noted above, member states have different approaches to ethical standards and audit practices. Unless “maximum harmonisation” takes the highest standards from across the European Union, there is a risk to audit quality as firms engage in regulatory arbitrage.

4.21 We would stress that audit firms and their largest clients operate in a global market and not a solely European one. For enhanced supervision to be successful, action will need to be taken on an international scale – perhaps through a global college of regulators or similar. In pursuit of this objective we would be supportive of a greater role for IFIAR.

5. Further information

For further information please contact Paul George, Director of Auditing, on +44 20 7492 2340 (email: p.george@frc-pob.org.uk).

APPENDIX A - GREEN PAPER QUESTIONS AND ANSWERS

Introduction	
Q1	Do you have general remarks on the approach and purposes of this Green Paper?
A1	<i>We believe that the Green Paper identifies the key issues and challenges facing audit policy and regulation. With all relevant issues on the table we have the opportunity to develop a complete answer.</i>
Q2	Do you believe there is a need to better set out the societal role of the audit with regard to the veracity of financial statements?
A3	<i>There is an expectation gap between the actual scope of an audit and public perception of what it should reveal. Our main submission discusses ways in which greater transparency on the conduct and outcome of the audit could narrow that expectation gap.</i>
Q3	Do you believe that the general level of “audit quality” could be further enhanced?
A3	<p><i>As noted in our main submission, the FRC’s priority is to preserve and enhance audit quality. A great deal has been done in recent years in this regard, including the development of the clarity ISAs, the introduction of independent audit inspections and, in the UK, the publication of the Audit Quality Framework. However we believe more could be done. In particular, we would like to see auditors exercise greater scepticism and we discuss this further in our response to Q6. We would also like to see greater promotion of the key drivers of audit quality amongst companies and audit committees, as well as a willingness by firms to compete on audit quality. The adoption of a governance code for audit firms may also enhance audit quality, and this is discussed further in our response to Q22.</i></p> <p><i>The most recent round of audit inspections in the UK found that, while major firms usually have policies and procedures appropriate to their size and client base, those procedures were not always being applied consistently in practice. This is a behavioural issue and firms must ensure that appropriate incentives and sanctions are in place to encourage personnel to exhibit the correct behaviours.</i></p>
Role of the auditor	
Q4	Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?
A4	<p><i>It is important to distinguish between the financial health of a company at the balance sheet date and the state of that company twelve or eighteen months later.</i></p> <p><i>Under current company law and standards the auditor provides comfort on two things:</i></p> <ul style="list-style-type: none"> <i>(i) whether the balance sheet and related statements present a true and fair view of the financial health of the company at that date; and</i> <i>(ii) that it was reasonable for the directors to prepare the accounts on a going concern basis which implies that it was reasonable for the directors to assume that they would be able to pay their debts as they fall due for the next twelve months.</i>

	<p><i>No forward-looking analysis can be proof against the impact of unforeseen events, and so the comfort provided in relation to directors' going concern statements ((ii) above) cannot provide complete assurance that companies will always be able to meet their future liabilities. It is therefore clearly different in character from the assurance auditors give with respect to the financial statements ((i) above).</i></p> <p><i>The FRC will shortly be consulting on a number of proposals that are designed to:</i></p> <ul style="list-style-type: none"> <i>• improve risk identification and reporting by company management;</i> <i>• address the extent of assurance in relation to such matters; and</i> <i>• increase transparency in relation to the key assumptions used to determine the appropriateness of the going concern basis for the preparation of financial statements.</i>
Q5	To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?
A5	<i>Rather than greater transparency of the audit methodology, we favour greater transparency of specific information around the conduct and outcome of the audit. We believe that this can be dealt with via the audit committee report as set out in paragraphs 3.8 to 3.10 of our main submission.</i>
Q6	Should "professional scepticism" be reinforced? How could this be achieved?
A6	<p><i>Following the financial crisis there have been questions about whether auditors exercised sufficient professional scepticism in the course of their audit work – in particular when considering 'fair values' attributed to certain types of assets. Similar concerns have also arisen in the course of recent audit inspections.</i></p> <p><i>Application of appropriate professional scepticism is vital as, unless auditors are prepared to challenge management's assertions, they will not be able to confirm, with confidence, that a company's financial statements give a true and fair view. In our audit inspections we have noted a number of instances of firms failing to apply sufficient professional scepticism in relation to key audit judgements.</i></p> <p><i>Firms must ensure that their recruitment, appraisal and promotion policies reward personnel who demonstrate appropriate professional scepticism in their work. Corporate behaviour also plays a role, and audit committees should ensure that auditors do not fear removal if they challenge management assumptions.</i></p> <p><i>The FRC has recently published a discussion paper⁶ on these issues. In the light of the responses that are received both to this paper and to another recent publication⁷, careful consideration will be given to developing further measures to increase the exercise of professional scepticism in the course of an audit. Those measures may take the form of enhancements to professional qualifications and to auditing standards, or to the way</i></p>

⁶ 'Auditor scepticism: raising the bar', FRC/APB, 2010

⁷ 'Enhancing the auditor's contribution to prudential regulation', FRC/FSA, 2010

	<i>professional scepticism is addressed in the recruitment, development and retention of audit personnel.</i>
Q7	Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?
A7	<i>We believe that our proposals for greater transparency by audit committees on the outcome of the audit together with improved engagement with investors should help minimise the shortcomings in a binary audit opinion.</i>
Q8	What additional information should be provided to external stakeholders, and how?
A8	<i>In the UK the FRC's Guidance to Audit Committees encourages companies to disclose certain facts about the company's relationship with its external auditors, including the tenure of the auditors, contractual restrictions on the choice of auditor and details of any non-audit services provided by the auditor. We would encourage widespread disclosure of these and other relevant matters relating to the effectiveness of the external audit and suggest that report of the audit committee is the most appropriate vehicle for this.</i>
Q9	Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?
A9	<i>The frequency and effectiveness of the dialogue between external audit, internal audit and the Audit Committee will vary between companies. The FRC produces Guidance to Audit Committees in an attempt to assist audit committees with these relationships. We believe that the proposals set out in paragraph 3.10 will enhance this.</i>
Q10	Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?
A10	<i>We do not believe that the audit report itself should be extended to cover CSR reporting and similar matters. However, if audit committees and/or investors thought it appropriate, the company's CSR performance could be the subject of a separate assurance report as envisaged in paragraph 3.11 of our main submission.</i>
Q11	Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year end and the date of the audit opinion be reduced?
A11	<i>We support greater transparency on the scope and findings of the audit, but as noted above we believe that the most appropriate vehicle for communication to investors and other interested parties is the audit committee report.</i> <i>We would not support reducing the time gap between the year end and the issue of the audit opinion. Audit firms are already under pressure at certain times of the year due to the large number of companies with December year ends. Reducing the time available for the auditor to gather and analyse audit evidence would be a risk to audit quality.</i>
Q12	What other measures could be envisaged to enhance the value of audits?
A12	<i>See section 3 of our submission.</i>
Q13	What are your views on the introduction of ISAs in the EU?
A13	<i>As noted in our main submission, we support the adoption of the clarity ISAs in the EU. The clarity ISAs have already been adopted in the UK and Ireland from the end of 2010.</i>

Q14	Should ISAs be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing for the endorsement of International Financial Reporting Standards (IFRS)? Alternatively, and given the current widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?
A14	<i>As noted in our main submission, we would favour enshrining the objectives and requirements of the ISAs in legislation, but dealing with their application via a Recommendation.</i>
Q15	Should ISAs be further adapted to meet the needs of SMEs and SMPs?
A15	<i>We believe that the same set of auditing standards should apply to the audits of all companies. We would note that in the development of the clarity ISAs, the IAASB was conscious of the need for audits to be proportionate in relation to entities of all sizes, and that guidance intended specifically to aid the application of the ISAs to assist the application of the ISAs is included within them. Further guidance for smaller audits, such as that produced in the UK by the FRC's Auditing Practices Board, may be helpful.</i>
Governance and independence of audit firms	
Q16	Is there a conflict between the auditor being appointed and remunerated by the audited entity?
A16	<i>The FRC's concern is less with the appointment and remuneration of the auditor by the audit client than with the "agency problem" more generally, which arises because of the owner/manager split in most large companies. The responsibility of auditors is to investors but in practice the auditor is appointed by the company's management. This is not a new problem and it is clear that there continues to be significant over the risks to auditors' objectivity as a result of the current arrangements. Suggestions to address this issue have included:</i> <ul style="list-style-type: none"> • <i>Tightening of independence rules</i> • <i>Mandatory firm rotation</i> • <i>Mandatory re-tendering of audits</i> • <i>Greater shareholder involvement in the appointment process, either via enhanced audit committee disclosure or consultation with principal investors.</i> <p><i>The FRC tends to favour increased onus on audit committees and investors to engage in more detailed discussions on audit quality related issues.</i></p>
Q17	Would appointment by a third party be justified in certain cases?
A17	<i>Auditors have a specific responsibility to shareholders. We would be supportive of measures to increase the extent of shareholder involvement in appointing and removing auditors. We do not believe it would be appropriate for the primary responsibility for appointment to lie with a third party such as a regulator. Inter alia, it could lead to a conflict of interest if the regulator was also responsible for monitoring and discipline of the firm in question.</i> <p><i>We would not be opposed to regulators operating enhanced licensing or competency systems, including restrictions on the firms/individuals who would be permitted to conduct public interest audits or audits in particular industries (eg banking). This could be taken a step</i></p>

	<i>further, with a requirement that audit appointments in systemic institutions be subject to positive approval from the relevant regulator.</i>
Q18	Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of the appointment?
A18	<i>See Q29 on mandatory rotation.</i>
Q19	Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?
A19	<p><i>As noted in our main submission, we are in favour of a tightening of auditor independence rules but would not support a complete ban on the provision by firms of non-audit services to audit clients. The UK's Ethical Standards, which impose requirements over and above the IFAC code, address the main threats to auditor independence and may serve as a starting point for discussion.</i></p> <p><i>We do not see a need for different restrictions on the services which can be provided to financial institutions. We would note that there is no evidence that the provision of non-audit services to audit clients was a factor in the financial crisis.</i></p>
Q20	Should the maximum level of fees an audit firm can receive from a single client be regulated?
A20	<p><i>Major firms must balance the short-term impact of the loss of a major client with the longer term reputational impact of failing to provide unwelcome advice where necessary. Setting a limit on the fees an audit firm can receive from a single client helps to ensure that no one client is so significant to the overall long term success of a major firm that it is worth risking its reputation for. In the UK the Ethical Standards set the maximum level of fees that an audit firm can receive from a single client, expressed as a percentage of the audit firm's annual fee income, at 10% for listed companies and 15% for other entities.</i></p> <p><i>It is also important to recognise the risk created by the significance of individual clients to the reputation and profile of individual partners within major firms and to establish appropriate safeguards to mitigate against this.</i></p>
Q21	Should new rules be introduced regarding the transparency of the financial statements of audit firms?
A21	<i>In the UK the transparency reporting requirements of the Statutory Directive, when taken together with the obligation for firms constructed as limited liability partnerships or companies to publish accounts and the UK profession's voluntary code of practice on the disclosure of audit profitability provides sufficient transparency of audit firms' financial statements. We would support a similar approach across the EU and any efforts by the Commission to promote greater transparency of the major global networks.</i>
Q22	What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?
A22	<i>The UK has recently implemented a governance code for auditors of significant numbers of</i>

	<i>public interest entities. The Code includes a number of measures intended to strengthen governance, compliance and risk management within firms and includes a provision for the appointment of independent non-executives. We would support the introduction of similar arrangements across the EU.</i>
Q23	Should alternative structures be explored to allow audit firms to raise capital from external sources?
A23	<i>In principle we believe that it should be possible to change the current rules governing the ownership of audit firms without risking audit quality. Alternative ownership structures, including the possibility of raising capital from external sources, have the potential to make it easier for firms to invest to allow them to expand into the market for the audits of the largest companies. Research carried out by Oxera indicated that the cost of capital in a partnership was considerably higher than in an ownership model which allowed for external investment.</i> <i>Significant expansion by non-Big Four firms into the audit market for very large companies would be expensive and, given the infrequency of tenders, may take a number of years to be successful. The partnership structure mitigates against such expansion as existing partners may be reluctant to invest into an activity which would only show a return after some time, possible after their retirement.</i>
Q24	Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?
A24	<i>We agree with the Green Paper's suggestions regarding group auditors.</i>
Supervision	
Q25	Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?
A25	<i>We support the creation of a European Supervisory Authority for audit. Refer to paragraphs 4.12 to 4.14 for more detail on this proposal.</i>
Q26	How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved?
A26	<i>This is particularly important in the case of financial services entities. In the UK auditors of large financial services entities already have a duty to report matters of concern to the relevant regulator. The joint FRC/FSA paper referenced above envisages a closer working relationship between auditors and regulators, including regular meetings.</i> <i>If regulators believe there are systemic risks in other industries then an extension of the reporting obligation to non-financial services companies may be an appropriate way to deal with those concerns, perhaps via a wider whistle-blowing responsibility for auditors of listed companies.</i>
Concentration and market structure	
Q27	Could the current configuration of the audit market present a systemic risk?
A27	<i>The market for the audits of largest companies in the UK, in common with most other member states, is highly concentrated. This causes a number of difficulties, which are explored in section 2 of our main submission.</i>
Q28	Do you believe that the mandatory formation of an audit firm consortium with at least

	<p>one smaller, non systemic audit firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?</p>
A28	<p><i>Joint audits in the UK have become less common in recent years. There is a perception that they are more costly and that audit quality can suffer as key judgements fall between the two firms. The FRC has also had reports of company management playing firms off against each other when it comes to accounting treatments. For these reasons we would not support the mandatory use of joint audits or audit firm consortia.</i></p> <p><i>However, we believe that there are alternative ways to give non-Big Four firms access to the largest companies, for example via the appointment of such firms as advisers to risk committees.</i></p>
Q29	<p>From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?</p>
A29	<p><i>Large listed companies put their audit out to tender infrequently, with some retaining the same auditor for over fifty years. The lack of real alternatives and the difficulty companies face in distinguishing between the major firms may be factors in this, but whatever the reasons, concentration in the market will not reduce unless companies change auditor more frequently.</i></p> <p><i>Other advantages to mandatory rotation include the introduction of a fresh approach to the conduct of an audit and the key judgements involved and that the proposal addresses concerns that auditors become too close to the company they audit and its management through a natural desire to retain the audit.</i></p> <p><i>However, there is the potential for mandatory rotation to have a negative impact on audit quality. This conclusion is supported by research undertaken by FEE in October 2004. There is a higher risk of audit failure in the first two years of a new audit appointment, as the new firm familiarises itself with the business's processes and key risk areas. Independence requirements (the new auditor would be forced to withdraw from many other commercial relationships with the client) and client concerns about confidentiality (for example, if the proposed auditor also audited a major competitor) are likely to mean that many companies would have a very limited choice of firm to switch to. We would also note that there is evidence of unintended consequences where mandatory rotation has been introduced; for example, the core audit team moving en masse to the newly appointed firm.</i></p> <p><i>An alternative to mandatory rotation would be mandatory re-tendering after a fixed period of time; or, at a minimum, a rebuttable presumption that the audit is put to tender every [10] years. Companies would be required to report to shareholders on the reasons for the audit appointment which resulted from that tender. This would allow the company wished to retain the incumbent auditor if it wished to do so, but would ensure it justified its decision to shareholders.</i></p>

	<p><i>The practical difficulties of both mandatory rotation and re-tendering are explored in paragraphs 2.13 to 2.14 of our main submission. In view of these the FRC would support instead increased shareholder involvement in the appointment and re-appointment process.</i></p>
Q30	<p>How should the “Big Four bias” be addressed?</p>
A30	<p><i>The biggest challenge to the “Big Four bias” is one of perception. Large companies would prefer there to be more than four major firms to choose from but are reluctant themselves to choose a non-Big Four auditor because they are concerned about reactions from investors, brokers, lenders and others.</i></p> <p><i>There is no easy solution to this issue of perception. Increased transparency from firms and regulators may in time provide companies with greater confidence in the abilities of non-Big Four firms; provided of course that those firms provide audits of sufficient quality. For example, other member states could follow the UK’s example in publishing the results of independent inspections of individual audit firms. Such a measure could support non-Big Four firms demonstrating to potential clients their ability to deliver high quality audits.</i></p> <p><i>However, as noted above, there needs to be a much higher level of tenders to allow non-Big Four firms to enter the market.</i></p>
Q31	<p>Do you agree that contingency plans, including living wills, could be key in addressing systemic risks and the risks of firm failure?</p>
A31	<p><i>Effective cross-border contingency plans are vital to minimising the disruption which would arise from a large firm leaving the audit market. Paragraphs 2.5 to 2.7 of our main submission sets out our views in more detail.</i></p>
Q32	<p>Is the broader rationale for consolidation of large audit firms over the past two decades (ie global offer, synergies) still valid? In which circumstances, could a reversal be envisaged?</p>
A32	<p><i>The largest global companies require an auditor with sufficient international reach to service their operations appropriately. This requirement has not changed since the major consolidation in the market began in the 1980s.</i></p> <p><i>However, we believe that it should be possible for more than four firms to provide that international reach, and we would note that the larger mid-tier firms in any case have significant global networks of their own. Additionally, only the very largest companies have substantial global operations. Mid-tier firms may not have the resources to audit the very largest and most complex companies, but they are quite capable of auditing a far broader range of companies than is currently the case.</i></p> <p><i>Finally, we would note that it is clear with hindsight that it would have been better had competition authorities blocked the Price Waterhouse/Coopers & Lybrand merger in 1998.</i></p>

Creation of a European market	
Q33	What in your view is the best manner to enhance cross border mobility of audit professionals?
A33	<i>We would encourage co-operation between professional bodies on the audit qualification and related matters and believe that, where appropriate, audit experience gained in other member states should be recognised.</i>
Q34	Do you agree with “maximum harmonisation” combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?
A34	<i>We have no objection to the creation of a single European passport for auditors and audit firms, provided that opportunities for audit firms to engage in regulatory arbitrage are minimised. We would suggest that smaller firms be given the opportunity to obtain the passport, but that this is not a requirement if they wish to operate solely in one member state.</i> <i>We would be reluctant to support “maximum harmonisation” if this meant that the lowest standards across member states became the norm. This would be to the detriment of audit quality.</i>
Simplification: small and medium sized enterprises and practitioners	
Q35	Would you favour a lower level of service than an audit, a so called “limited audit” or statutory review for the financial statements of SMEs instead of a statutory audit? Should such a service be conditional depending on whether a suitably qualified (internal or external) accountant prepared the accounts?
A35	<i>As noted above, we believe that all audits should be conducted using the same auditing standards. We would be supportive of a rise in the threshold for statutory audit and/or removing certain subsidiaries of large companies from the audit regime, provided that appropriate safeguards (for example an agreement from the parent company to guarantee the liabilities of its subsidiaries) were in place.</i>
Q36	Should there be a “safe harbour” regarding any potential future prohibition of non-audit services when servicing SME clients?
A36	<i>There is reduced public interest in the audit of some smaller companies, especially when they are owner-controlled. We do not object to auditors of such companies being permitted to provide a wider range of non-audit services than may be provided to listed companies, provided that the degree of the auditor’s objectivity is clear. UK Ethical Standards address this via the Auditing Practices Board’s ‘Provisions for Smaller Entities’.</i>
Q37	Should a “limited audit” or “statutory review” be accompanied by less burdensome internal quality control rules and oversight by supervisors? Could you suggest examples of how this could be done in practice?
A37	<i>As noted above we believe that all audits should be conducted using the same auditing standards, but that it may be possible to exempt from audit a wider group of entities than is currently the case.</i>
International co-operation	
Q38	What measures could in your view enhance the quality of the oversight of global audit players through international co-operation?

A38	<p><i>We would support greater co-operation between national regulators on matters such as audit inspections and the oversight of the global network bodies, as well as the formation of a college of regulators.</i></p> <p><i>International co-operation would be vital in the event of a large firm finding itself in difficulty.</i></p>
-----	--