

STATEMENT OF Mr PAUL BOYLE  
CHIEF EXECUTIVE, FINANCIAL REPORTING COUNCIL (UK)  
BEFORE THE  
ADVISORY COMMITTEE ON THE AUDITING PROFESSION

WASHINGTON, DC – 3 DECEMBER 2007

Mr Chairmen and Members of the Committee,

It is my privilege to appear here today as the Chief Executive of the Financial Reporting Council (FRC) the United Kingdom's independent regulator responsible for promoting confidence in corporate reporting and governance. The FRC has six strategic outcomes which contribute to our overall aim, covering corporate governance, corporate reporting, auditing, actuarial practice, professionalism of accountants and actuaries and our own effectiveness as a regulator. Within our auditing outcome, we recognise the importance of an efficient market for audit services in the UK.

I hope that our mission means that we are in a position to assist the Committee in its review of the sustainability of the US auditing profession.

Over the last eighteen months we have facilitated a public debate in the UK about the efficiency of the market for audit services in the UK. I have submitted the results of that debate in the FRC's response to the Committee's Discussion Outline ( [http://comments.treas.gov/\\_files/051107LettertoTreasuryAdvisoryCommittee.pdf](http://comments.treas.gov/_files/051107LettertoTreasuryAdvisoryCommittee.pdf) ). My testimony today does not repeat that response but is focussed on how the work that we have facilitated in the UK might be relevant to the issues now being considered by the Committee in relation to Firm Concentration and Competition.

The debate in the UK has been facilitated by the FRC but has had considerable participation by market participants, including companies, investors and auditors. The debate went through several stages. It started with a general view that the current situation in respect of firm concentration and competition posed some risks to the

capital markets and to the wider aspects of the economy which rely on the availability of audited financial statements. Informed by an independent study of the market prepared by a firm of economic consultants, it evolved to recognise that the primary risk was of uncertainty and costs in the event of one or more of the Big Four firms leaving the market. There was general agreement that there would be serious difficulties in the market if the number of major firms fell from four to three. It is neither possible nor desirable to reduce to zero the risk that one of the existing major firms would leave the market.

This led to broad agreement that the fundamental issue was one of auditor choice rather than competition issues such as pricing or quality. It was also agreed that the most attractive way to address the issue was to enhance the efficiency of the market, whilst protecting or enhancing audit quality and avoiding unacceptable costs. Stakeholders also expressed a clear preference for market-led actions, rather than regulatory interventions, to address the issues. However, there was recognition that the audit market has been subject to extensive regulatory requirements for some years and that, as a result, enabling actions by professional bodies, regulators or legislators may be needed.

The FRC established a Market Participants Group (MPG), which consisted of investors, companies and audit firms, to advise the FRC on possible actions that market participants could take to mitigate the risks arising from concentration in the market. The MPG developed, following a public consultation, 15 recommendations to achieve a more efficient market by assessing and addressing the market characteristics that were acting together to limit choice. The process adopted by the MPG leads me to believe that there is extensive support from across the UK market for both the need for change and the selected means of achieving it.

I believe that the Group's recommendations will result in individual market participants having greater incentives to act in ways that could, in the long term, lead to increased choice of auditors. Non-Big Four firms should have greater incentive and ability to invest in the supply of audit services. Boards of directors should be more accountable to their shareholders for their auditor selection decisions and should find selecting a non-Big Four firm, in suitable circumstances, less risky. Shareholders

should be better informed about the capabilities of different audit firms and less concerned about decisions to select a non-Big Four firm, in suitable circumstances.

We are now in the implementation phase of our work. The FRC's response to the Committee's Discussion Outline, to which I referred earlier, included a table summarising the plans for implementing the MPG's recommendations. The FRC has also made a commitment to report publicly every six months on the progress on implementation.

Although the issues faced by your Committee are considerably wider than those considered by the FRC during this debate, in the area of Concentration and Competition there are likely to be a number of important parallels.

In our work on choice in the audit market we have explicitly recognised the importance of audit quality and auditor liability. Although the issues are inter-related, we found it convenient, for reasons of focus, to have separate projects on choice, audit quality (see, for example, our most recent publication on audit quality <http://www.frc.org.uk/press/pub1418.html> ) and auditor liability (see, for example, the announcement of our project <http://www.frc.org.uk/press/pub1352.html> ).

Throughout our extensive deliberations and consultations on this issue we were unable to identify one specific measure which of itself would substantially lower the risks. It is for that reason that the MPG produced a package of 15 recommendations each of which address different aspects of the problem.

My own view is that the recommendation which has the greatest long-term potential to reduce the level of risk is the one relating to the ownership of audit firms. To increase choice it is necessary for one of the existing smaller firms to grow at a rapid rate or for there to be a major new entrant. For either of these to happen substantial capital will be needed to fund the investment required. The existing ownership rules are a major constraint on the potential rate of investment.

Concerns have been raised about the risks to auditor independence and audit quality arising from changes to the ownership of audit firms. I believe that some of those

concerns are overstated and that others are capable of being mitigated. And, of course, the risks of change need to be weighed against the risks associated with the status quo. The FRC is currently preparing a discussion paper on this topic which I will be happy to send to the Committee when it is published in early 2008.

There was a view in the UK that this is an international issue and one that could only be addressed through international cooperation. Rather than respond by doing nothing, we took the view that useful progress could be made in the UK alone. However, we also recognised that progress on some issues would be faster and more effective if complimentary solutions were adopted in other major countries. We hoped that the debate in the UK could make a useful contribution to a wider international debate. In this context we regard the establishment of your Committee and the work being done by the European Commission (see, for example <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1570&format=HTML&aged=0&language=EN&guiLanguage=en> ) as being very significant developments.

I look forward to contributing to the Panel discussion and answering your questions.



## **CHOICE IN THE UK AUDIT MARKET**

### **FRC UPDATE**

**OCTOBER 2007**

#### **Introduction**

This FRC Update on the Choice in the UK Audit Market project sets out the FRC's response to the advice of the Market Participants Group's (MPG) final report. It describes how the MPG's recommendations will be implemented including actions to be taken by the FRC. It also summarises progress made since the last FRC Update in April 2007 by regulators in the UK and internationally in reducing risks to the availability and quality of audits.

#### **Implementation of the MPG recommendations**

The MPG has published its final report setting 15 recommendations for changes intended to enhance the efficiency of the audit market and to mitigate the risks associated with a firm leaving the market. The recommendations are consistent with stakeholders' preference for market-led actions rather than regulatory interventions. They are substantially unchanged from the MPG's provisional recommendations published in its Interim Report, for which there was broad support.

The tables on pages 3 to 7 summarise how the MPG's recommendations will be implemented. The recommendations are ultimately targeted to audit firms, companies and investors, although in some cases enabling actions by professional bodies, regulators or legislators may first be needed and these are shown in the tables.

Any material changes to regulatory arrangements will be assessed for proportionality and effectiveness, with stakeholders being consulted before decisions are taken.

#### **Regulatory actions outside scope of MPG**

It is likely to take some years before the efficacy of the actions proposed by the MPG can be assessed. The FRC will monitor the implementation of the recommendations but currently believes that it is appropriate not to take any further regulatory action in respect of objective A, increased choice of auditors.

For objective B, reduced risk of a firm leaving the market without good reason, and objective C, reduced uncertainty and disruption costs in the event of an audit firm leaving the market, there could be a greater need for regulatory action. The FRC has been working with other regulators to prepare an audit continuity plan that is intended to help ensure a continued supply of high quality audits in the event of the possible,

or actual, loss of a major audit firm. It should be noted, however, that the ability of regulators to avoid uncertainty and disruption in the markets is limited.

## **International**

Audit choice and continuity continue to be the subject of international debate. International developments since the last FRC Update in April include:

- In May the US Treasury announced that it will charter a non-partisan federal advisory committee to develop recommendations on ways to strengthen the auditing profession. Former SEC chairman Arthur Levitt and former SEC chief accountant Donald Nicolaisen were asked to co-chair the advisory committee and the full membership of the committee was announced in October (see <http://www.treas.gov/offices/domestic-finance/acap/>). The committee will examine auditing industry concentration, financial soundness, audit quality, employee recruitment and retention, in addition to other topics. The US Treasury expects the committee to produce findings and recommendations by early summer 2008.
- The European Commission published responses to its consultation on possible reform of liability rules in the EU in June. The EC-commissioned independent study on ownership rules applying to the audit firms and their consequences on audit market concentration is expected to be published shortly.
- Observers from international regulatory organisations attended the FRC's stakeholder meeting discussing the MPG's Interim Report that was held in May and held further discussions.
- The International Organization of Securities Commissions is identifying the range of possible considerations by securities regulators in the event of a crisis relating to a major audit firm.
- At the International Forum of Independent Audit Regulators meeting in Toronto in September 2007, IFIAR members received reports on the steps taken in some jurisdictions to examine the issues of concentration and choice in the audit market.

## **Monitoring**

The FRC will make a public report every six months on progress in implementing the recommendations. Key Facts and Trends, an annual publication of the FRC's Professional Oversight Board, will monitor concentration in the market.

## Implementation arrangements for recommendations targeted at audit firms

<i>MPG recommendation</i>	<i>Efficient market characteristics</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
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.	A.1.1: Increased actual capabilities of non-Big Four firms.	FRC to prepare and consult on discussion paper on the possible effects on audit choice of changes to audit firm ownership rules	Q2 2008
		FRC to use discussion paper to influence legislative change in the European Union and the US.	2008
		Existing or new non-Big Four Firms consider raising substantial equity finance.	2010?
2: Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.	A.1.2: New firms with the capabilities required by public interest entities enter the market	Guidance for the voluntary disclosure of financial results of audit work to be prepared.	Q2 2008
		Firms start to report on a voluntary basis using the guidance.	2009
3: In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.	A.1.3: Non-Big Four willing to be appointed as auditor of more public interest entities.	FRC to send the recommendation to the working group preparing guidance on auditor liability limitation agreements, the European Commission, the US Treasury and other relevant authorities.	October 2007 & ongoing
		Further consideration of policy in European Union and the US.	2008
		Existing or new non-Big Four firms consider further investment.	2010?
4: Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.	A.1.4: More accurate perceived capabilities of non-Big Four firms.	FRC to review policies on membership of their boards and committees.	Q2 2008
		FRC to send recommendation to International Auditing and Assurance Standards Board, the International Accounting Standards Board, and member bodies of the Consultative Committee of Accountancy Bodies.	October 2007
		Non-Big Four firms demonstrate their involvement in standard setting bodies and committees.	2008 onwards

<i><b>MPG recommendation</b></i>	<i><b>Efficient market characteristics</b></i>	<i><b>Implementation arrangement</b></i>	<i><b>Expected timing</b></i>
<b>5:</b> The FRC should continue 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.	A.2.1: Increased understanding of audit quality and of the capabilities of individual firms.	The FRC has recently published a paper setting out the drivers of audit quality, based on an earlier discussion paper.	Q4 2007
		Firms report publicly on their capabilities in line with the drivers of audit quality. The Audit Inspection Unit will monitor and report publicly on firms' capabilities in line with the drivers of audit quality.	From 2008
<b>6:</b> The auditing profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.	A.2.2: Reduced risk and cost of changing auditors.	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.	Q2 2008
		Firms start to follow new arrangements. Audit Inspection Unit considers effectiveness of new arrangements.	From Q3 2008
<b>11:</b> 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.	A.3.1: Only necessary factors constrain supply to major public interest entities.	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 the standards. In so doing it will have regard to the views raised in this debate on particular ethical standards.	Q2 2008
		FRC to send recommendation to the International Ethics Standards Board for Accountants and the SEC.	October 2007
		Firms compete for audits taking account of any changes to the ethical standards.	From 2009
<b>14:</b> 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.	B.2: Reduced value of meritorious claims against audit firms.	The ICAEW to form a working group to develop a Combined Code -style best practice corporate governance guide for auditors of public interest entities.	Q4 2008
		Firms consider and follow the new corporate governance guide.	From 2009



## Implementation arrangements for recommendations targeted at companies

<i>MPG recommendation</i>	<i>Efficient market characteristic</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
7: 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 audit network.	A.2.3: Companies more willing to appoint auditors from more than one network.	FRC to prepare draft guidance and publish this for comment.	Q4 2007
		FRC to publish and distribute the final guidance.	Q2 2008
		Companies consider guidance.	Q3 2008 onwards
8: The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision.	A.2.4: Clearer information on boards' auditor selection decisions.	The FRC will prepare revised guidance for audit committees (the Smith Guidance).	Draft revised guidance to be published for comment Q1 2008 and finalised by Q3 2008.  Companies consider guidance Q3 2008 onwards
9: When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms	A.2.5: Corporate advisers and brokers more willing for clients to appoint non-Big Four.		
12: The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.	A.3.2: Only necessary factors constrain use of Big Four by major public interest entities.		
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.	C.1: Actions taken before the possible loss of an audit firm.		

<i>MPG recommendation</i>	<i>Efficient market characteristic</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
<b>13:</b> Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.	B.1: Appropriate response by the market when issues arise.	FRC and its operating bodies to review policies on regulatory penalties and publish for discussion outline details of any proposed changes.  The FRC will also raise the matter with its regulatory counterparts in other major jurisdictions.	By Q3 2008
		Companies consider their response to any audit firm incident taking account of available information on regulatory penalties.	2009 onwards

## Implementation arrangements for recommendations targeted at investors

<i><b>MPG recommendation</b></i>	<i><b>Efficient market characteristic</b></i>	<i><b>Implementation arrangement</b></i>	<i><b>Expected timing</b></i>
10: Investor groups, corporate representatives, firms and the FRC should promote good practices for shareholder engagement on auditor appointment and re-appointments.	A.2.6: Increased shareholder engagement on auditor selection.	Investor groups consider information published by companies through recommendation 8 and firms through recommendation 2, 5 and 14.	Starting 2008
		Investor groups consider need for any revisions to existing guidance on shareholder engagement on auditor selection in light of availability of improved information described above.	Starting 2008



Choice in the UK Audit Market  
Final Report of the Market Participants Group  
October 2007

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## Executive Summary

The Market Participants Group was established in October 2006 to provide advice to the Financial Reporting Council 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. The Group is comprised of individuals from companies, investors and audit firms.

In establishing the terms of reference of the Group, the FRC noted the importance of audit quality and the need to avoid actions that would damage audit quality.

The Group noted that due to the level of auditor concentration there is a high degree of concern amongst market participants over the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. This risk could be mitigated through increased choice of auditors. However a number of current market characteristics, when taken together, reduce the propensity of existing or new non-Big Four firms to make 'step change' investments in their capability to audit public interest entities and the propensity for public interest entities to select non-Big Four firms as auditors.

The Group evaluated a wide range of possible actions to increase choice of auditors. In its evaluation the Group sought to identify possible actions which would, when combined with others, contribute to increased choice whilst at least maintaining audit quality at a cost which is proportionate to the likely benefits and at a cost which is lower than any alternatives offering equivalent benefits. It found no 'silver bullets' that could rapidly increase choice at a proportionate cost whilst maintaining audit quality.

The Group is grateful to those who commented on its provisional recommendations including the major investor and corporate representative bodies as well as individual audit firms and other market participants. This report describes how it has taken account of the comments made.

This report sets out recommendations for actions which the Group believes could, when taken together, enhance the efficiency of the market and in so doing mitigate the risks associated with a firm leaving the market.

The main objectives of the 15 recommendations are to:

- Increase the feasibility of investment in the supply of audit services to public interest entities by existing non-Big Four firms or new firms
- Reduce the perceived risks to directors of selecting a non-Big Four firm
- Improve the accountability of boards for their auditor selection decisions
- Improve choice from within the Big Four
- Reduce the risk of firms leaving the market without good reason
- Reduce uncertainty and disruption costs in the event of a firm leaving the market.

The recommendations set out actions that could be taken by market participants working collectively, some of which require support from regulators, to allow the market to work more efficiently.

The Group considers that the package of recommendations could have a positive impact on the degree of concentration in the supply of audit services to all but the very largest public interest entities over the medium term. In the longer-term this may provide a platform for non-Big Four firms who successfully respond to the opportunities created to expand into the audit market for the very largest public interest entities.

The recommendations could also reduce the risk of a firm leaving the market without good reason and contribute to mitigating the uncertainty and disruption costs in the event of a firm leaving the market.

The Group hopes that there will be a wide degree of support for the package of final recommendations and that agreement over market-based measures in the UK will make a useful contribution to the wider international debate on audit market concentration.

The Market Participants Group has now completed its work in accordance with its terms of reference.

\* Public interest entities means entities that are of significant public relevance because of the nature of their business, their size or the number of their employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings.

## Introduction

## Introduction: The market for audits of public interest entities

- As shown in Table 1, most large listed companies purchase their audit services from the Big Four audit firms – Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers. This high level of supply concentration follows mergers between audit firms over many years and the dissolution of Arthur Andersen. The Big Four's overall share of the FTSE 350 has been fairly constant for several years. Between 10 and 20 companies within the FTSE 350 change auditor each year, usually within the Big Four (Table 2).
- Audit is a public interest function and the operation of the market is subject to extensive legislative and regulatory requirements.
- Several features of the market for audit services to public interest entities contribute to the tendency of public interest entities to use the largest audit firms with the strongest existing brands and reputations:
  - In selecting and appraising auditors, audit committees look at the 'added value' that firms bring to the company – including accountancy advice and the limitation of the personal and reputational damage of significant accounting misstatements.
  - It is more difficult to assess objectively the quality of an audit firm without experience of working with that firm.
  - Non-executive directors and others selecting or influencing the selection of auditors are more likely to have experience of working with the (now) Big Four rather than non-Big Four firms.
  - The process of switching auditors can be costly for both the companies and auditors.
- Reflecting the current market structure, most major public interest entities perceive they have a choice of a maximum of four audit firms. This choice can be further limited by auditor independence regulations if companies choose to use Big Four firms for certain non-audit work or if the audit firms have certain types of financial, business, employment or personal relationships with the company. Choice appears to be particularly limited for some financial services companies.

**Table 1 Number of companies audited by firm, August 2007**

Auditor	FTSE				Small Cap	AIM
	FTSE 100	(2005)	FTSE 250	(2005)	/ Fledgling	
PwC	39	(43)	73	(82)	120	122
Deloitte	21	(17)	66	(54)	100	128
KPMG	21	(22)	57	(64)	102	187
Ernst & Young	19	(17)	43	(42)	113	115
BDO Stoy Hayward	0	(1)	6	(4)	15	141
Grant Thornton	0		4	(1)	43	213
Begbies Chettle Agar	0		1	(1)	1	0
Baker Tilly	0		0		9	94
PKF	0		0		9	55

**Source:** Based on Hemscoff February 2007 (2005 comparisons from Oxera, page 60).

Note 1: Segro & Close Brothers shown as clients of Deloitte, Thomas Cook as client of PricewaterhouseCoopers.

Note 2: For all UK-domiciled non-FTSE 350 companies on the main market, the proportion using Big Four is similar to that shown above for FTSE Small Cap i.e. around 85% use Big Four.

**Table 2 Percentage of listed companies in 2004 that switched auditors 1996-2004**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	Avg.
Listed companies (%)	3.0	4.4	6.2	4.5	3.5	4.9	5.5	3.4	2.8	4.2
FTSE 100 (%)	2.0	0.0	1.9	1.6	3.1	2.9	2.6	3.8	1.2	2.1
FTSE 250 (%)	0.7	3.2	4.9	2.4	0.6	3.9	4.9	2.7	1.6	2.8
FTSE Small Cap (%)	3.2	4.1	7.4	5.2	4.6	5.9	4.5	3.2	3.1	4.6

**Source:** Oxera, page 44, based on the Oxera panel dataset that included companies that appeared in the relevant main market index in 2004 and for which data was available.



## **Introduction (ii): Background to formation of the Market Participants Group**

The objectives of the 'Choice in the UK Audit Market' project are to identify, assess and promote actions to enhance the efficiency of the market for the audit of public interest entities in the UK and mitigate the risks arising from the characteristics of the market. The intended outcomes from this project include:

- Increased choice of auditors (Objective A)
- Reduced risk of an audit firm leaving the market without good reason (Objective B)
- Reduced uncertainty and disruption costs in the event of an audit firm leaving the market (Objective C).

In undertaking this project, the FRC recognised the importance of the quality of audit work and committed to avoiding actions that would damage the quality of audit services.

Details of the project are available at <http://www.frc.org.uk/about/auditchoice.cfm>.

In the first stage of the project the FRC:

- Jointly with the Department of Trade and Industry commissioned a study, "Competition and Choice in the UK audit market", which was published in April 2006
- Published a Discussion Paper for consultation in May 2006
- Facilitated a public debate by hosting two stakeholder meetings (in April and September 2006) and publishing responses to the Discussion Paper.

During the first stage of the project, it emerged that the nature of the risks associated with the current characteristics of the market for the audit of major public interest entities are such that actions may be required by each of:

- Market participants acting individually
- Market participants acting collectively
- Regulatory authorities
- Government and legislators.

Those who participated in the first stage of the project had a strong preference for market-led solutions. The Market Participants Group was established in October 2006 to provide advice to the FRC and, in particular, to identify and assess possible actions which market participants could take to mitigate the risks arising from the characteristics of the market.

## Introduction (iii): The Market Participants Group

The Market Participants Group comprises individuals from stakeholder groups in the market for the supply of, and demand for, audit services to public interest entities in the UK. The three principal stakeholder groups are:

- The entities being audited
- The firms providing audit services
- Shareholders and other users of audit services.

A list of members of the Group is shown in the Appendix. In line with its terms of reference, the Group has:

- *Defined the risks arising from the characteristics of the market:* The Group noted that due to the level of auditor concentration there is a high degree of concern amongst market participants over the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. In addition some market participants consider that there would be benefits from increasing choice from the current level.

- *Defined the criteria by which possible actions to mitigate risks should be assessed:* The Group decided that possible actions should, when combined with others, contribute to achieving the intended outcomes whilst at least maintaining audit quality, at a cost which is proportionate to the likely benefits and at a cost which is lower than any alternatives offering equivalent benefits.

- *Carried out a high-level assessment of a 'long list' of possible actions:* The Group evaluated a wide range of possible actions that could help to manage the risk. It considered current market characteristics identified in the Oxera study, the characteristics that might be found if the market was to operate more efficiently, and actions to help achieve such enhanced efficiency that were suggested in the first stage of the project.

- *Carried out further assessment of a selection of possible actions to mitigate risks:* The Group recognised that the intended outcomes could only be achieved through the actions of individual market participants. However, changes to the way the market operates would be needed so that individual market participants had greater incentive to act in ways that would achieve these outcomes. It would not be feasible to achieve the outcomes through one, or a few, actions to change the way the market operates. The Group therefore developed a package of actions, some of which require support from regulators, which it considered would best meet the agreed criteria.
- *Reported on the outcome of the assessments:* The Group set out in its interim report in April a package of possible actions which it believed could result in individual market participants having greater incentive to act in ways that could lead to increased choice of auditors, reduced risk of an audit firm leaving the market without good reason and reduced uncertainty and disruption costs in the event of an audit firm leaving the market.
- *Reported conclusions:* This report explains how the Group has taken account of the comments it received on its interim report and sets out the Group's conclusions and final recommendations.

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## Findings and recommendations

## Findings and recommendations: Objective A – Increased choice of auditor for public interest entities

- The Group considers that increased choice for public interest entities requires both an increase in the propensity of non-Big Four firms to offer to audit public interest entities (the “**supply side**”) and an increase in the propensity for public interest entities to select non-Big Four firms as auditors ( the “**demand side**”). The effectiveness of actions on the supply side would be enhanced by those on the demand side and vice versa.
- On the **supply side** the Group believes that the principal responsibility for the decision to make this investment and to secure appropriate sources of finance rests with individual firms. The most important development would be additional investment by the existing non-Big Four firms or new firms in perceived and actual capabilities to audit public interest entities. The following recommendations are designed to make such investment more feasible:
  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. (Pages 18-19)
  2. Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis. (Pages 20-21)
  3. In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality. (Pages 22-23)
  4. Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms. (Pages 24-25)
- On the **demand side** the Group believes that the primary responsibility for the selection of auditors of public interest entities should remain with their boards. However to help achieve the intended outcomes for the project, the risks to 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 following three recommendations are designed mainly to reduce the risks associated with choosing to select a non-Big Four firm:
  5. The FRC should continue its efforts to promote understanding of audit quality and the firms and the FRC should promote greater transparency of the capabilities of individual firms. (Pages 28-29)
  6. The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor. (Pages 30-31)
  7. 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 audit network. (Pages 32-33)

## **Findings and recommendations (ii): Objective A – Increased choice of auditor for public interest entities (ii)**

- The next three recommendations are directed at improving the accountability of boards for their auditor selection decisions.
  - 8. The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision. (Pages 34-35)
  - 9. When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms. (Pages 36-37)
  - 10. Investor groups, corporate representatives, auditors and the FRC should promote good practices for shareholder engagement on auditor appointments and re-appointments. (Pages 38-39)
- The Group is aware that its recommendations on the demand side could result in an increased rate of audit tendering, particularly for companies that have not actively considered alternatives to their incumbent auditor for many years. The Group considers that companies would only need to incur the cost of putting the audit out to tender when they judge that a change of auditor could be beneficial.
- Because it could take many years before additional investment could contribute to a meaningful increase in choice for the very largest public interest entities, the choice available to many of those entities is restricted to the Big Four firms. The Group has, therefore, also considered how to increase the potential for switching between the Big Four firms. The Group believes that recommendations 6 and 7 could contribute to increased choice for the very largest public interest entities. In addition:
  - 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. (Pages 42-43)
  - 12. The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors. (Pages 44-45)

## **Findings and recommendations (iii): Objective B – Reduced risk of a firm leaving the market without good reason**

- Because it could take many years for the recommendations under Objective A to lead to increased choice of auditors for major public interest entities, the market is likely to be faced for some time with a significant risk of uncertainty and disruption in the event of a major audit firm leaving the market. Although there could be circumstances in which it might be entirely appropriate that a firm should leave the market, it is also possible that firms might leave the market without good reason. The Group identified three main ways in which the risk that a firm might leave the market without good reason could be reduced:
  - Increasing the likelihood that the market responds appropriately to an issue which might potentially cause a firm to leave the market.
  - Reducing the value of meritorious claims against audit firms.
  - Increasing the resources available to firms to deal with claims against them.
- In increasing the likelihood that the market responds appropriately to an issue which might potentially cause a firm to leave the market, the primary responsibility must remain with the firm itself. Companies also have a role in planning for how they monitor and react to news about their audit firm. The Group considered that market participants needed greater visibility and clarity of the possible level of regulatory penalties on an audit network of rule breaches:
  13. Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness. (Pages 48-49)
- In reducing the value of meritorious claims against audit firms, it was noted that the firms themselves have strong incentives to govern their affairs in such a way as to minimise risks. However the Group considered that users of audit services should be given information about the firms' corporate governance arrangements and that these should comply with standards equivalent to those of public companies:
  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. (Pages 50-51)
- In increasing the resources available to firms to deal with claims against them the Group noted that changes to auditor liability arrangements, as envisaged by recommendation 3, might in the long term improve the availability of insurance although this is not certain particularly at the top end of the market.

## **Findings and recommendations (iv): Objective C – Reduced uncertainty and disruption costs in the event of a firm leaving the market**

- Because, notwithstanding the recommendations under Objectives A and B, it would be both impossible and undesirable to eliminate the possibility of a firm leaving the market, the Group considered how it might be possible to reduce the uncertainty and disruption costs which would result. Although some of the responsibility for planning for the continuity of audits, or alternatives to audits, rests with regulators and government, there are actions which market participants could take before the possible loss of a firm and actions which would only be required in the event of a firm leaving the market.
  - In particular the Group considered that it was appropriate for major public interest entities to consider the need to manage the risk of the loss of their auditor:
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. (Pages 54-55)

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## Analysis of consultation responses and final recommendations



## Criteria for assessing recommendations

The Interim Report invited comments on the criteria used for assessing the merits of the provisional recommendations:

Whether actions would, when combined with others, contribute to achieving the intended outcomes

- Whilst at least maintaining audit quality; and
- At a cost which is proportionate to the likely benefits and which is lower than alternatives offering equivalent benefits.

There was general support for the criteria used for assessing the merits of the provisional recommendations.

The need for thorough cost-benefit analysis of actions as part of the assessment was suggested. As set out in the Interim Report, each of the provisional recommendations was assessed for effectiveness, impact on quality and cost. It is envisaged that more detailed assessment of the costs and benefits of significant regulatory changes would be carried out during the implementation stage of the project.

It was suggested that 'relevance' should be added as a criteria and that the overall impact, and the impact on different sizes of companies, should be considered. The Group's test of whether actions would achieve the intended outcomes is intended to include consideration of relevance and impact.

### Comments on criteria

We support the above criteria. They properly recognise the need to maintain audit quality, which is of paramount importance. Although not given explicit recognition in the criteria, there is an implicit need to ensure that recommendations do not diminish the audit market's existing effectiveness which underpins the delivery of audit quality. The cost of the proposals will be small in relation to the magnitude of securities trading, but we agree that some regard should be had to the relative efficiency of alternative proposals. *ACCA*

Whilst we are broadly supportive of the three criteria used for assessing the merits of the provisional recommendations we believe that, with regards to effectiveness, they are currently expressed in terms that are too general and, moreover, that the focus needs to be on those 'high impact' changes that would have the greatest impact in practice. *Mazars*

Yes, although we feel that one other criteria - relevance - needs to be considered. In particular, solutions that may be appropriate to smaller domestic UK companies may not be relevant to large complex multinational businesses. *National Grid*

We agree, of course, that each action proposed by the report, either by itself or when combined with others, should contribute to achieving the intended outcome. Cost-benefit is also an important consideration and we would be keen to see the FRC developing better and more sophisticated criteria for assessing cost-benefit compared to the way that regulatory impact assessments are currently performed by government departments. *Herbert Smith*

## General comments

Views on specific recommendations are summarised in the pages in this section for each recommendation. Some responses made general comments on the package of recommendations and a selection of these is shown in the box on the right.

The interim report also invited views on any additional characteristics of a more efficient market that should be considered. The general view was that the analysis had included all relevant market characteristics.

### Examples of general comments

We can therefore broadly support the thrust of many of the recommendations, particularly if viewed as a package, but would clearly need to have further consultations and discussions with CBI members in the light of how the MPG or the FRC intends to take the recommendations forward in furtherance of the objectives. *CBI*

Audit costs are a significant overhead for many of our members and we therefore would welcome the development of a more competitive market especially for fully listed companies. [...] [we] are supportive of the overall package. *Quoted Companies Alliance*

We recognise there is a real risk that a reduction in choice and competition would occur in the event that the Big Four were reduced in number. However, we do not believe it is in the market's interest to prevent a reduction in audit choice at all costs. [...] The Hundred Group supports market driven change rather than regulatory intervention. *Hundred Group of Finance Directors*

The supply and demand side recommendations should encourage the development of a healthier market and we would like to see the FRC take these forward as a matter of urgency. *NAPF*

In general, IMA supports the MPG's provisional recommendations and hopes that once they are finalised, the FRC will seek to encourage the relevant market participants to implement them as a matter of priority. *Investment Management Association*

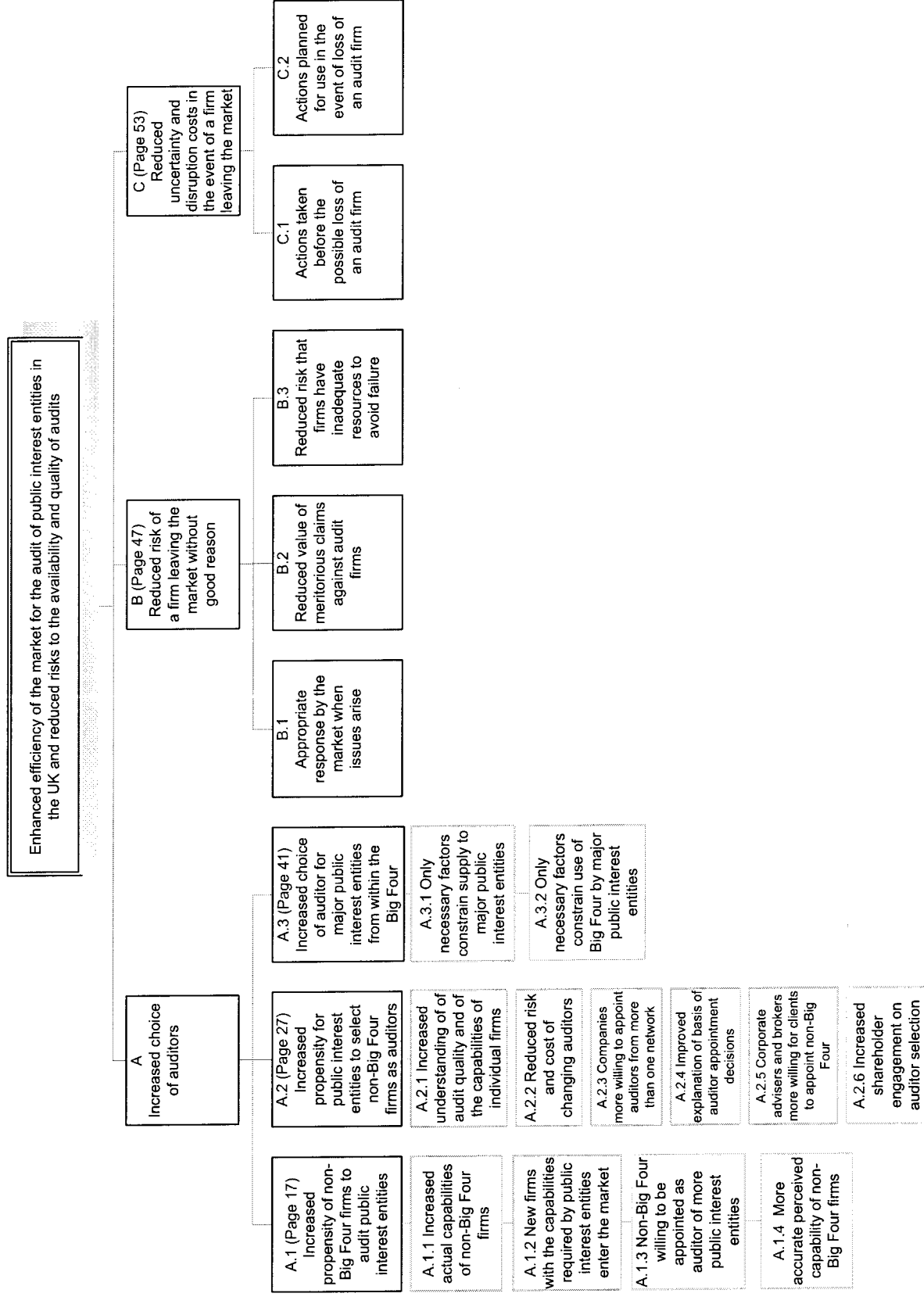
The recommendations for change, by and large, have the potential to make a helpful contribution towards increasing choice. Whether that potential is to be realised will depend on how the recommendations are to be implemented, and consequently we await with interest the FRC's next steps. *Independent Audit Limited*

In isolation, none of the recommendations will serve to increase choice and it is questionable whether they will do so collectively. *Baker Tilly*

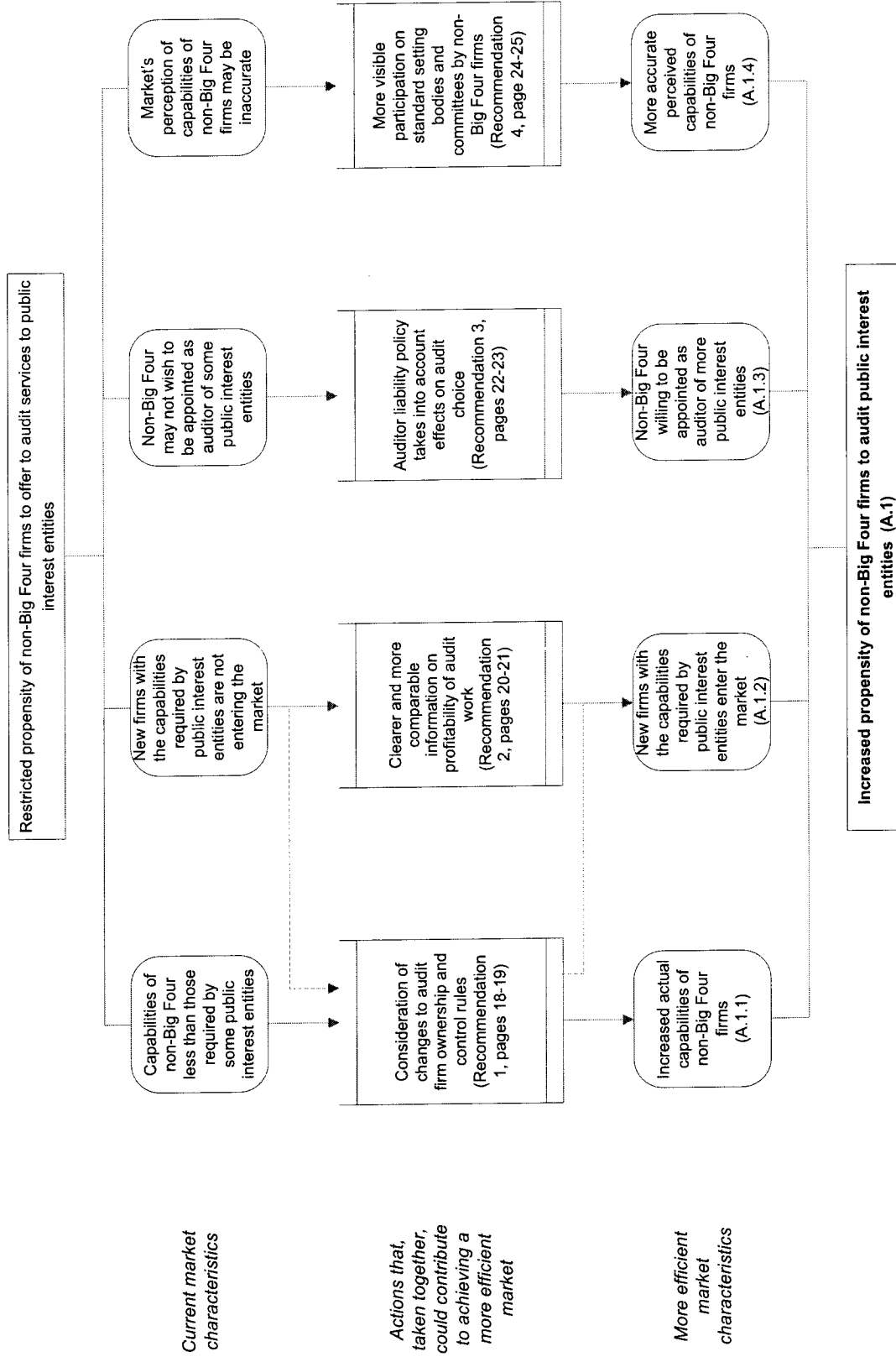
We believe that some of the recommendations could bring valuable improvements to the overall effectiveness of the audit market, but they are unlikely to have any significant impact on the stated objectives, and some may prove to have no effect at all on choice. *Ernst & Young*

[The MPG] has not made the case for significant change, a number of the proposals potentially weaken the quality of global audit, there is currently appropriate competitiveness within the market and the regulatory and independence requirements imposed on auditors has improved audit quality. *Peter Smith*

## Summary of objectives of recommendations



## A.1 Increased propensity of non-Big Four firms to audit public interest entities - Summary



## Recommendation 1: Audit firm ownership and control rules

Current market characteristics	Background
<ul style="list-style-type: none"> <li>The Oxera study concluded that there are significant economic barriers to immediate new entry into the market for audit of major public interest entities. While operating in the FTSE 100 and FTSE 250 segments can be in principle be profitable, Oxera found, the initial expansion would require substantial investment.</li> <li>The ability of firms to raise external capital to finance the investment is restricted by the Companies Act (and by European law) which requires audit firms to be controlled by qualified auditors. Given the multidisciplinary nature of audit firms, a sizeable percentage of partners and owners are not auditors, limiting firms' ability to raise even small amounts of equity finance without restructuring.</li> <li>The scale and risk of the investment required might not be attractive to some of the partners of existing non-Big Four firms as a result of limits, due to retirement, on the period that they can personally receive a return on the investment.</li> </ul>	<p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>The ability of existing or new audit firms to raise substantial external equity finance for investment is limited.</li> <li>Some existing non-Big Four firms may be limited in the degree by which they can rely on partners' funds to make a step change in the level of investment in capacity to deliver audit services to the FTSE 350 segment.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Should operating in the FTSE 350 segment have the potential to be profitable for a non-Big Four firm, that firm should be able to raise the necessary investment.</li> <li>Controls over the ownership and control of audit firms do not exceed the level necessary to protect audit quality.</li> </ul> <p><b>Provisional recommendation 1</b></p> <ul style="list-style-type: none"> <li>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.</li> </ul>

### Consultation responses

#### Effectiveness

There was general support for promoting wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, although it was noted that benefits of such changes were likely only in the longer term.

The significance of audit firm ownership rules to the business environment in which these firms operate should not be underestimated as it affects firm structure, availability of capital, propensity to use insurance. Although there may not be a strong desire for change from current arrangements it should not be assumed that this will necessarily remain the case and it is desirable to give serious thought to the implications of change. *Association of British Insurers*

This is potentially the most powerful recommendation. CIMA believes that there is a case for liberalising the audit firm ownership rules subject to appropriate safeguards and preferably accompanied by liability reform. *CIMA*

From our discussions with existing Tier A firms, we do not believe that the current ownership rules and current limits on sources of capital are a barrier to their growth. However, we still believe that this proposal has merit as allowing different sources of capital for firms may allow the creation of entirely new structures for auditing which might mark a step-change in the current market. *Hermes*

Some responses doubted whether changes to the ownership rules would benefit audit choice.

Recommendations 1 and 2 add little to the debate as firms will make any necessary investment (and generally have the resources to do so already) should commercially sensible business opportunities arise. The issue is that no firm is going to invest heavily in an area in the hope that some work may or may not subsequently materialise. *Baker Tilly*

We have no reason to believe, either from our own experience or from what others have said, that the current audit firm ownership rules have "constrained step changes in future investment" by existing or new firms. We therefore doubt that changing the rules will bring any benefit. *PricewaterhouseCoopers*

The need for any work arising from the recommendation to be coordinated with that of the European Commission was noted.

We note the European Commission has commissioned a study on ownership rules applying to audit firms and the consequences these rules have on audit market concentration. It would seem sensible for the FRC to plan its promotional activities such that they can be informed by the study and enjoy any benefits accruing there from. *Standard Life Investments*

## Recommendation 1: Audit firm ownership and control rules (ii)

### Consultation responses (continued)

#### Quality

The need for consideration of the effects of changes in the ownership rules on auditor independence and audit quality, as envisaged in the provisional recommendation, was confirmed.

We believe this recommendation merits further investigation, with significant issues such as public interest, accountability, independence and ownership to be considered. In our initial discussions, arguments have been raised both for and against any changes to audit firm ownership rules and the introduction of external capital. Concerns have been expressed, however, that de facto control of or even significant influence over an audit firm by non auditors could impose commercial pressures that rest uneasily with the auditors' public interest duties and their independence. *ICAS*

The principle of divorcing effective regulatory requirements from ownership structures is well-established in many other industries and it should be workable within the audit industry. *CIMA*

#### Cost

There was concern over the cost of any additional safeguards that might be needed to protect auditor independence and audit quality.

As we stated in our 2006 response, we believe that, in principle, quality requirements could be applied to firm operations rather than ownership, thus liberalising the provision of capital without compromising audit quality. Note that we state 'rather than ownership' as it would be counterproductive if any change to regulatory requirements to achieve this added to the overall regulatory burden. *ICAEW*

We support the objective of the provisional recommendation as wider understanding can promote more choice. However, we believe that the structural ownership of audit firms is not an area that requires complex change process and any change here would be complex both in terms of existing regulations and new regulations. We would support the existing structure. *Standard Chartered*

Equity finance is more expensive than debt finance, which is easier and less costly to access and manage. The extra returns, which will need to be generated by the audit firm to meet equity finance costs, may be prejudicial to good audit quality. At the very least, it will be necessary for the FRC to demonstrate how it has satisfied itself that there is no risk to audit quality from any changes to the ownership rules and that no additional costs are imposed on those firms who do not choose to avail themselves of any more liberal ownership rules. *PricewaterhouseCoopers*

### Conclusions

Market participants are generally in favour of further consideration of changes to audit firm ownership and control rules. Some responses questioned whether any firms would need or wish to raise substantial equity finance given the availability of debt finance. This is unlikely today but more likely if other changes to the market have the effect of improving the business case for substantial investment.

The European Commission is expected to lead a debate over possible legislative change in this area. The FRC's work in response to this recommendation would contribute to that debate. In addition to considering whether and how audit firms might wish to raise equity finance, the FRC should suggest how auditor independence and audit quality could be maintained by firms that were not majority owned by auditors.

In principle regulatory requirements that relate to audit quality and independence could be applied to the operations of firms rather than to their ownership. Many aspects of the auditing activities of firms are already regulated but if additional regulation of firms controlled by non-auditors was found to be necessary then the costs would need to be shown to be proportionate to the benefits.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

### Recommendation 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.**

## Recommendation 2: Disclosure of financial results of statutory audits and directly related services

Background	Consultation responses
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>▪ The Oxera study concluded that, unless market conditions and perceptions change, the investment required for substantial entry into the FTSE 100 and FTSE 250 segments was unlikely to be economic.</li> <li>▪ In order to assess the business case for investment, potential entrants could make use of the accounts of existing firms amongst other sources of information. Large audit firms report in accordance with IFRS which requires segmental reporting based on how an entity manages its business. Most publish financial results split by lines of service that typically include audit / assurance, tax and advisory services.</li> <li>▪ Some firms allocate all revenue and cost to such service lines whereas others show substantial amounts as 'unallocated'.</li> <li>▪ The audit / assurance segment will, depending on the firm concerned, include revenue from a range of services other than statutory audits and directly related services. Fees for such non-audit services represented up to 45% of turnover reported under the audit / assurance service line in the 2006 financial statements for the five of the six largest firms by turnover that published segmental analysis.</li> </ul> <p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>▪ The financial results for audit services provided by the firms may be difficult to interpret. They may include or exclude different indirect costs and different types of assurance services.</li> <li>▪ Potential new entrants and others may find it difficult to assess whether investment in the supply of audit services to public interest entities is attractive.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>▪ Information on the firms' financial results for statutory audits and directly related services is transparent and comparable, helping potential new entrants and others to assess the viability of the supply of these services.</li> </ul> <p><b>Provisional recommendation 2</b></p> <ul style="list-style-type: none"> <li>▪ Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.</li> </ul>	<p><b>Effectiveness</b></p> <p>Some respondents agreed that more information on profitability could improve market efficiency</p> <p>Transparency of reporting is an essential component of an efficient market and given that the requirement for an audit in the UK is a statutory one it appears entirely appropriate for audit firms to disclose the level of profitability of that business. <i>Amlin</i></p> <p>We fully endorse increased transparency in the financial results of the audit firms. KPMG was the first firm to publish its financial results and already includes segmental disclosures in accordance with IFRS that provides an analysis of revenue, operating profit and assets of the audit business segment, including revenue in respect of statutory and regulatory attestation audit work. We would be happy to work with the FRC to develop a comparable basis for reporting. <i>KPMG</i></p> <p>Yes, this is relevant information that we would expect to be in the public domain. Given the importance of the subject it is disappointing that relevant information necessary to make informed judgements had been lacking. <i>Association of British Insurers</i></p> <p>Others suggested that sufficient information for prospective market entrants is already available.</p> <p>Accounts for the largest UK firms (Big Four and mid tier) have been available for many years with no impact on choice. Further disclosure, by service type, is unlikely to attract additional firms to the market, as any firm with aspirations to compete in this area will already understand the commercial drivers. <i>Ernst &amp; Young</i></p> <p>It was suggested that if information is to be provided, guidance to firms on how to produce it would be needed.</p> <p>Guidance to the firms should be clear to ensure consistency and, whilst the allocation of costs may be difficult, this should not be an obstacle to pursuing this option. <i>Aggreko</i></p> <p>Given the nature of the industry in which the audit firms operate, we believe that they should demonstrate current best practice in all aspects of business reporting, both financial and non-financial. One such example of emerging best practice is provided by the Report Leadership project in which CIMA is an active participant. <i>CIMA</i></p>

## Recommendation 2: Disclosure of financial results of statutory audits and directly related services (ii)

### Consultation responses (continued)

#### Quality

There were differing views on the impact of the provisional recommendation on audit quality.

We support the stated objective of the recommendation. We agree that this recommendation complements the recommendation to change audit firm ownership rules. We would rate the impact on quality as likely significant over time (as opposed to 'limited direct effect') on the premise that improved information should lead audit firms into allocating more senior time into statutory audits. *International Corporate Governance Network*

The firms are made up of experienced accountants who fully understand the benefits of margin analysis; yet have separately concluded that this particular margin is not a useful basis on which to manage audit quality. Indeed, we would be concerned if audit margins were a primary driver in managing statutory audit work. We believe the market will soon share this understanding, but sadly the cost of changing business processes may have already been incurred. *Ernst & Young*

#### Cost

Firms would incur extra reporting costs but there were differing views on how substantial these would be.

[...] the significant differences in audit firms' management structures, client base and internal charging arrangements that may make the provision of meaningful comparisons both costly and complex indicate that regulators should be cautious in imposing additional burdens on audit firms. *National Grid*

Given that listed companies require clear separation of the various components of fees payable to their auditors, the segmentation of audit revenue should be relatively simple. Whilst we accept that allocation of costs may be more difficult, clear disclosure of the methodology of allocation would be better than simply leaving substantial amounts unallocated. The audit firms should be trying to apply similar standards of segmentation of disclosure to that to which their clients are committed. The argument that material extra costs would be incurred developing systems to measure cost is not convincing. *Amlin*

### Conclusions

A feature of an efficient market is the availability of information about profitability in that market. More information about the profitability of statutory audits and directly related services could help non-Big Four firms to assess the business case for investment. This information may be of limited use today but it could become more valuable if other changes to the market have the effect of improving the business case for substantial investment.

In addition to providing a breakdown of the revenue and direct costs of statutory audits and directly related services, firms would need to allocate indirect costs to this work where there is a reasonable basis for doing so. Appropriate guidance to the firms on providing this profitability information could help to achieve a reasonable degree of consistency and clarity whilst helping to keep the costs of reporting proportionate to the benefits.

Audit margins are not and should not become a primary driver in managing audit quality. Publication of the audit margin might however be a useful safety mechanism against excessive cost cutting during economic down-turns.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

### Recommendation 2

**Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.**



A.1 Increased propensity of non-Big Four firms to audit public interest entities  
**Recommendation 3: Auditor liability arrangements**

Current market characteristics	Background
<ul style="list-style-type: none"> <li>Currently liability of the auditor and the audited company towards others (shareholders, creditors) in the UK is joint and several. The statutory auditors and the audit firms may bear a portion of charges resulting from the misconduct of the audited company, in particular if that company goes bankrupt.</li> <li>The European Commission is considering whether there is a need to reform rules on auditors' liability in the European Union. In the U.K. the Companies Act of November 2006 permits contractual limitations between a company (subject to shareholders approval) and its auditor. The FRC has appointed a Group chaired by Sir Anthony Colman to develop guidance on auditor liability limitation agreements.</li> <li>Larger firms have, for many years, been unable to obtain comprehensive insurance for their liability risks. They have, in part, self-insured through the creation of captive insurance arrangements.</li> </ul>	<p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>Under the current arrangements, some non-Big Four firms may have limited incentive or motivation to audit major public interest entities. Average profit per partner in the largest non-Big Four firms is approximately £350,000 compared to around double that at Big Four firms. Partners in the non-Big Four firm would need to consider whether the prospect of closing this gap could justify what might be seen as a material increase in risk under current liability arrangements. Such a material increase in risk might come directly from taking on a significant client or indirectly from joining or strengthening an international audit firm network.</li> <li>The current liability arrangements could discourage new entry to the market and could be a significant reason why a firm might leave the market. The potential effects of auditor liability limitation agreements on Choice is unclear.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Liability arrangements provide a strong incentive to achieve high quality whilst, to the extent appropriate, not discouraging firms from participating in the audit of public interest entities.</li> </ul> <p><b>Provisional recommendation 3</b></p> <ul style="list-style-type: none"> <li>In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.</li> </ul>

Effectiveness	Consultation responses
<p>There was general agreement that liability risk can act as a constraint on audit market entry and that it was appropriate for those developing policy in this area to consider the effects on audit choice as well as audit quality.</p> <p>Limiting auditor liability would make auditing in general, and the audit of large [companies] in particular, more economically attractive. <i>Royal Bank of Scotland</i></p> <p>The liability issue if probably the major one in this debate and the smaller firms are likely to be discouraged from taking on larger audits with larger exposures. <i>Aggreko</i></p> <p>We believe that the promotion of auditor liability arrangements is very important for the promotion of choice in the audit market. However, a higher level of convergence between EU, governments and global regulators could make this even more effective given the global nature of audits for the largest organisations. <i>Ernst &amp; Young</i></p> <p>It was noted that existing firms might not be constrained by liability risk.</p> <p>[...] we do not believe that the absence of audit liability arrangements has had a significant effect on the willingness of a non-Big Four firm to be appointed as auditor to a public interest entity. <i>BDO Stoy Hayward</i></p> <p>It was suggested that Choice was a relevant factor to consider when implementing the new UK arrangements, although it was recognised that the scope for doing so might be limited.</p> <p>In principle, IMA supports liability reform and welcomes the FRC establishing a group to develop guidance on auditor liability arrangements. <i>Investment Management Association</i></p> <p>Obviously it would be counter productive if Liability Limitation Agreements, once established between the Big four audit firms and their clients, introduced a further barrier to mid tier firms attempting to compete with the Big Four. <i>Herbert Smith</i></p> <p>We are grateful to the FRC for agreement to appoint a working group to facilitate the adoption of audit liability limitation agreements. Government policy for auditor liability limitation was clearly and overtly permissive and, while market participants might decide to adopt one mechanism or another, the FRC will need to be careful that by regulatory action it does not subvert the intent of Parliament. <i>PricewaterhouseCoopers</i></p>	

A.1 Increased propensity of non-Big Four firms to audit public interest entities

### Recommendation 3: Auditor liability arrangements (ii)

#### Consultation responses (continued)

##### Quality

There was concern that further changes to liability arrangements could present risks to audit quality and should not be pursued.

Legislation now exists that may reduce auditor liability. Audits require quality systems and good people and a firm should enter this market only if it believes the risk: reward ratio is appropriate. It would not be acceptable to use audit liability capping primarily as a tool for increasing the number of market entrants. *Peter Smith*

Our view very strongly is that we need to see what impact on quality and on the marketplace the current changes to the liability of auditors has before any consideration is given to further changes. Especially given the debate on this issue in the EU at the moment, we do not believe that there is value in the Market Participants Group in pursuing this recommendation at the moment. *Hermes*

By giving the appearance of pushing hard for a reform that may be depicted as self-serving and reducing the incentives for audit quality, there is a risk of diminishing public trust in audits and of increasing the 'expectations gap' that the audit profession otherwise rightly wants to reduce. Rather than insisting on a quick legislative change on this issue, the profession should focus first on making its case to the investment community and other users of financial information. If liability reform were to diminish users' trust in audits, the accounting profession would have scored an own goal against its long-term interest. *Nicolas Véron*

##### Cost

No comments made

#### Conclusions

Market participants generally believe that those developing and implementing policy on auditor liability arrangements should take into account the effect of their decisions on the efficiency of the audit market. The fact that insurers choose not to underwrite risks of large auditors is a symptom of market inefficiency. Increased participation in the market by insurers is needed to help raise the prospect of increased choice of auditors.

Policy on auditor liability arrangements is already under review in Europe and in the U.S. The recommendation is directed at these existing reviews together with the implementation of the new UK arrangements. Those developing and implementing policy will need to be satisfied that audit quality is protected, but they should also take into account the impact of policy options on the attractiveness of investment in the supply of audit services as well as on the risk of a firm leaving the market.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

#### Recommendation 3

**In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.**

A.1 Increased propensity of non-Big Four firms to audit public interest entities

## Recommendation 4: Participation on standard setting bodies and committees

Background	Consultation responses
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>The Oxera study found that many stakeholders perceived there to be significant differences between the capabilities of the Big Four and non-Big Four firms. However non-Big Four firms have suggested that there are misconceptions in the market over their capabilities.</li> <li>Non-Big Four firms have suggested that these misconceptions are amplified as the auditing members of regulatory standard setters come predominantly from Big Four firms.</li> <li>Within the UK, both the Accounting Standards Board (ASB) and Auditing Practices Board (APB) currently do not have practising members who are from large non-Big Four firms. The ASB does have 2 non-Big Four practising members on its Urgent Issues Task Force. It also holds quarterly meetings with the technical partners of 11 firms. While not a formal part of the standard-setting process, it is a forum for the firms to get involved and share views. The APB also uses a group called the 'Technical Advisory Group' made up of technical partners of the largest 20 audit firms to obtain views on issues and to populate certain of its working parties.</li> <li>Significant aspects of the regulatory policy for corporate reporting and governance are now decided or heavily influenced by European or global organisations. Among these organisations, the International Accounting Standards Board has one practising member, who is from a Big Four firm, and the International Auditing and Assurance Standards Board has 18 members including eleven practising members, of whom eight are from Big Four firms, one from a large non-Big Four firm, and two from smaller practices.</li> </ul> <p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>Companies which wish to benefit from expertise on accountancy regulation may assume that they need to deal with the Big Four. As a result non-Big Four firms are less likely to be considered as credible candidates for public interest entity audits.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Non-Big Four firms act to reduce misconceptions in the market over their capabilities.</li> <li>Those purchasing or influencing the purchase of audit services are better informed as to the capabilities of both non-Big Four and Big Four firms.</li> <li>Regulators reduce misconceptions in the market by ensuring greater involvement of non-Big Four firms in regulatory standard setting.</li> </ul> <p><b>Provisional recommendation 4</b></p> <ul style="list-style-type: none"> <li>Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms</li> </ul>	<p><b>Effectiveness</b></p> <p>There was general agreement that non-Big Four firms need greater prominence in standard setting in order to avoid misconceptions in the market over their capabilities.</p> <p>We agree with the stated objective and believe that the proposed recommendation would achieve wider understanding of non-Big Four firms' capabilities and give more voice to such firms. <i>Standard Chartered</i></p> <p>This is a useful recommendation in that it should be straightforward to implement and could have a powerful impact in terms of improving the market perception of non-Big Four firms. We believe that these firms should find it a worthwhile investment of their time. <i>CIMA</i></p> <p>This is a sensible suggestion and goes to the core question of how much those firms want to invest in order to compete fully in the public interest audit market. <i>Governance for Owners</i></p> <p>It was noted that non-Big Four firms are already involved in standard setting.</p> <p>In our experience, such individuals are already involved and actively participate in such forums. We are not clear that additional effort needs to be expended in this area, especially as it is not clear to us what practical value would be served by any additional steps in this direction. <i>Hermes</i></p> <p>It was suggested that the recommendation was relevant to a wide range of regulatory bodies.</p> <p>We agree with the assessment of the recommendation. However, we believe that participation on standard setting bodies, including interpretation and advisory committees, is particularly important with respect to international standard setters such as the International Accounting Standards Board (IASB), the International Auditing and Assurance Standards Board (IAASB), and the International Ethics Standards Board for Accountants (IESBA). <i>International Corporate Governance Network</i></p> <p>We support this recommendation and believe it should be extended to the professional accountancy bodies with regard to chairmanships of technical committees and their nominations for international appointments, for example to FEE and IFAC. <i>Mazars</i></p>

## Recommendation 4: Participation on standard setting bodies and committees (ii)

### Consultation responses (continued)

#### Quality

It was suggested that appointing individuals from non-Big Four firms could help achieve higher quality accounting and auditing standards, but only if the principle of "best person for the job" remained paramount.

We agree that it would be beneficial if individuals from different sizes of audit firms, particularly those outside the Big Four, were to serve more frequently on standard setting bodies and other regulatory committees. Quite apart from issues of competition and choice, the more input that is received from different practitioners, the better standards and regulation are likely to be produced. *Herbert Smith*

The importance of the work of standard setting bodies is such that the only criteria for membership must be "best person for the job". There should be no bias in selection either towards, or away from, the Big Four. *PricewaterhouseCoopers*

#### Cost

It was noted that the cost of participation in standard setting bodies and committees can be considerable but this would be for individual firms to assess

It is appropriate to encourage participation by individuals from different sizes of firms. However, participation carries with it significant cost and it would be for the individual firms to assess whether the returns from involvement were appropriate. *Peter Smith*

Those non-Big Four firms that wish to engage more effectively in the UK audit market for larger public interest entities must be willing to participate in such groups. *BDO Stoy Hayward*

### Conclusions

Market participants generally believe that non-Big Four firms need greater prominence in standard setting, both in the UK and internationally. Non-Big Four firms already participate in standard setting but their involvement appears to be less prominent than that of the Big Four.

Participation in standard setting bodies and committees can involve a significant investment of time. Non-Big Four firms would be free to decide whether they wished to incur the cost of any further involvement.

The provisional recommendation referred to 'appropriate participation' which was intended to be consistent with the objective of selecting the 'best person for the job' given the benefits of diversity in membership. To further emphasise the importance of selecting the most skilled individuals it was decided to move the word 'appropriate' to before 'individuals'.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without further amendment.

### Recommendation 4

**Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.**

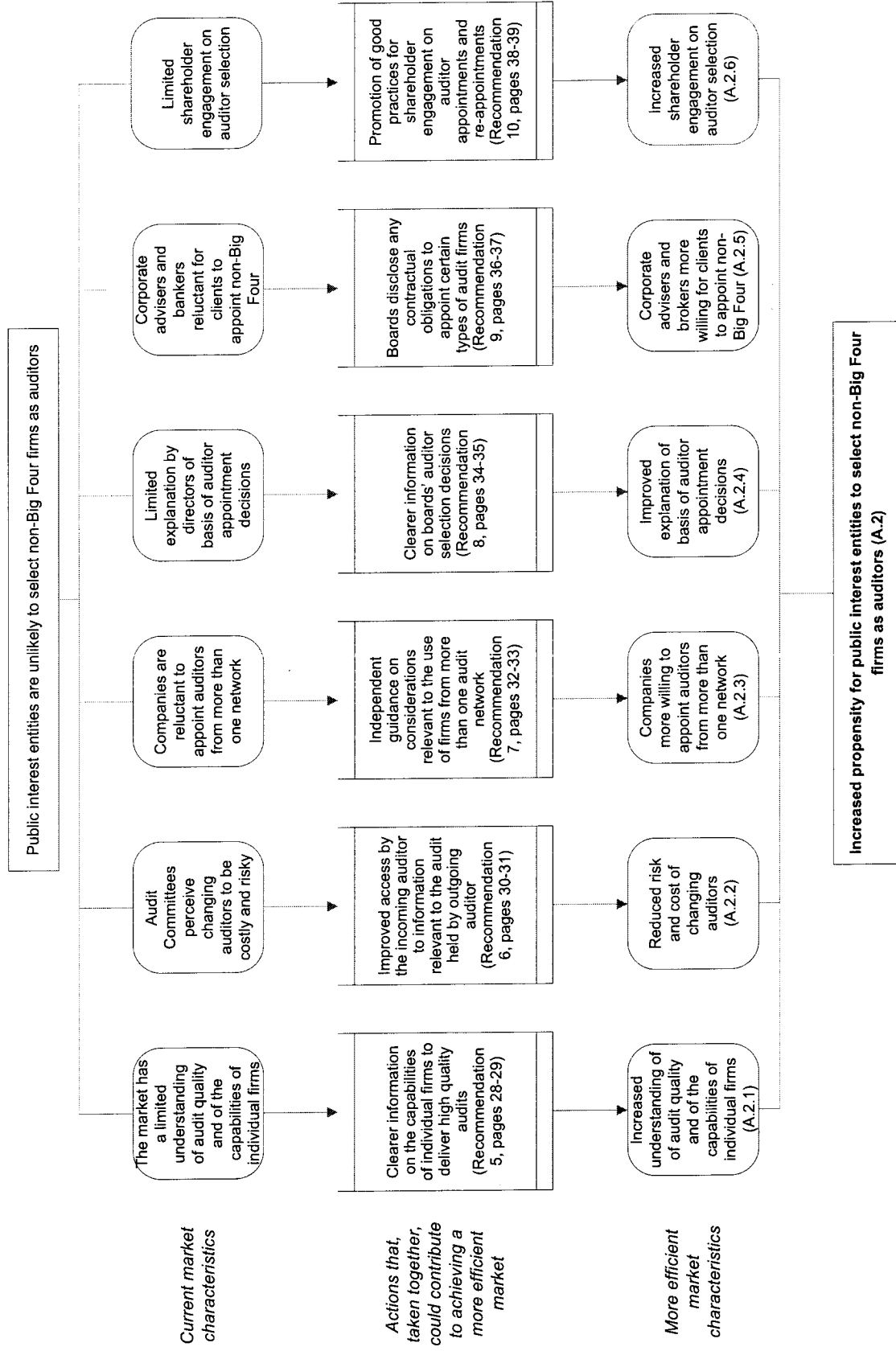
Abstract

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Abstract

## A.2 Increased propensity for public interest entities to select non-Big Four firms as auditors - Summary



## Recommendation 5: Transparency of the audit quality capabilities of firms

Current market characteristics	Background	Consultation responses
<ul style="list-style-type: none"> <li>The Combined Code on Corporate Governance recommends that audit committees assess the effectiveness of the audit process. They do so by considering aspects such as the audit team, quality processes, audit scope, communications, governance and independence. The Oxera study referred to audit as an 'experience good', whereby companies develop an understanding of the quality of the audit product they receive over a period of time.</li> <li>If it is difficult for company management and audit committee chairs to comprehensively and objectively assess the quality of the service they receive from their own auditor, it is especially difficult for them to assess the likely quality of service that could be expected from another firm. There is no single agreed definition of audit quality that can be used as a 'standard' against which firms can be assessed in the absence of direct experience of working with them. Shareholders have very little information on which to base any assessment of quality of auditors.</li> <li>Oxera found that many audit committee chairs said they did not know the non-Big Four firms very well. Finance directors and audit committee members may have experience of working with some (now) Big Four firms, but often not the non-Big Four.</li> </ul>		
<p><i>Effects of current market characteristics</i></p> <ul style="list-style-type: none"> <li>Difficulties in assessing audit quality result in a high dependence on the brand of an audit firm and its reputation in the process of auditor selection.</li> <li>Less than 10% of FTSE 350 companies surveyed by Oxera would have, at that time, considered using a non-Big Four firm.</li> </ul>		
<p><i>Characteristics of a more efficient market</i></p> <ul style="list-style-type: none"> <li>A stronger understanding of the drivers of audit quality that can be used as a 'standard' against which the capabilities of different audit firms can be assessed.</li> <li>Improved and comparable information on firms, in particular relating to the drivers of audit quality.</li> </ul>		
<p><i>Provisional recommendation 5</i></p> <ul style="list-style-type: none"> <li>The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency of the capabilities of individual audit firms.</li> </ul>		

### Current market characteristics

- The Combined Code on Corporate Governance recommends that audit committees assess the effectiveness of the audit process. They do so by considering aspects such as the audit team, quality processes, audit scope, communications, governance and independence. The Oxera study referred to audit as an 'experience good', whereby companies develop an understanding of the quality of the audit product they receive over a period of time.
- If it is difficult for company management and audit committee chairs to comprehensively and objectively assess the quality of the service they receive from their own auditor, it is especially difficult for them to assess the likely quality of service that could be expected from another firm. There is no single agreed definition of audit quality that can be used as a 'standard' against which firms can be assessed in the absence of direct experience of working with them. Shareholders have very little information on which to base any assessment of quality of auditors.
- Oxera found that many audit committee chairs said they did not know the non-Big Four firms very well. Finance directors and audit committee members may have experience of working with some (now) Big Four firms, but often not the non-Big Four.

### Effects of current market characteristics

- Difficulties in assessing audit quality result in a high dependence on the brand of an audit firm and its reputation in the process of auditor selection.
- Less than 10% of FTSE 350 companies surveyed by Oxera would have, at that time, considered using a non-Big Four firm.

### Characteristics of a more efficient market

- A stronger understanding of the drivers of audit quality that can be used as a 'standard' against which the capabilities of different audit firms can be assessed.
- Improved and comparable information on firms, in particular relating to the drivers of audit quality.

### Provisional recommendation 5

- The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency of the capabilities of individual audit firms.

### Effectiveness

There was general agreement that work to identify the drivers of audit quality is an important prerequisite to improved information on the capabilities of individual audit firms.

[...] we believe that the audit profession perhaps together with the help of other market constituents (including the FRC) need to more clearly define what "audit quality" should mean and provide the qualitative and quantitative measures that could be used to assess the "audit quality" definition. *The Hundred Group*

The objective of achieving transparency on the capabilities of audit firms is one which we consider boards and investors would greatly appreciate. With better information in the marketplace, boards and investors will be able better to benchmark the alternative audit providers and make better decisions on auditor selection. *Deloitte*

One thing the FRC could focus on here is the reporting by the Big Four and other large audit firms on their own governance and in particular the processes and policies in those firms designed to ensure audit quality is maintained and how they have operated in practice each year. Of special interest is how these policies and practices operate in relation to audits being carried out in more than one country for the same client. *Governance for Owners*

If audit firms disclose more information on matters such as their governance, client profiles, quality control procedures and policy issues faced, it will help better inform major shareholders and help them clarify their preferences between audit firms. In turn, they could make it clear, as a number have already, that they do not necessarily expect companies to seek an auditor from one of the Big Four. *Investment Management Association*

It was suggested that it should be for individual firms to promote their capabilities.

We tend to the view that it is up to individual firms to promote themselves by suitable investment in business development activities, as well as investment in the actual ability to carry out a wider range of audit roles. *Herbert Smith*

We believe that the firms themselves can and should make the biggest contribution to meeting the objective of increased understanding of audit quality and of the capabilities of individual firms by suitable disclosures (about for example audit inspections) and engagement with potential clients and their shareholders. *Royal Bank of Scotland*

A.2 Increased propensity for public interest entities to select non-Big Four firms as auditors

## Recommendation 5: Transparency of the audit quality capabilities of firms (ii)

### Consultation responses (continued)

#### Quality

It was suggested that clearer information on firms' capabilities as well as the results of audit inspections will contribute to audit quality.

For us, this is one of the most important areas for additional work. We greatly welcome the recent announcement by the Professional Oversight Board (POB) that it will seek to disclose firm-specific information on quality that is revealed in the course of its inspections. This would be an important step in enhancing quality and the transparency of quality and it reflects an earlier recommendation we made. We would note that in our view this transparency needs to be not of issues related to individual audits (because we fear this would have a pernicious defensive effect on those audits) but rather transparency of the bigger picture issues of culture, tone at the top and training. We will strongly encourage the POB to pursue this disclosure because we believe that it will ensure that auditing is less of a black box and therefore will open the door to much greater competition on the basis of quality rather than on price. *Hermes*

#### Cost

It was suggested that providing the information could be costly for firms.

[...] we believe that there is a cost implication for all audit firms, particularly in the initial stages of providing comparable information on capabilities and audit inspections, that favours the Big Four firms over smaller firms and may discourage smaller firms from competing in this market. *National Grid*

We believe that there are cost implications of this proposal but believe that the benefits will outweigh these costs. *BDO Stoy Hayward*

### Conclusions

Market participants generally believe that establishing a common understanding of the drivers of audit quality should form a useful basis for greater transparency of the capabilities of individual firms to deliver high quality audits.

It is largely for the firms to make the market aware of their capabilities and their potential to deliver high quality audits. However for this information to be useful it needs to cover the key drivers of audit quality and be broadly comparable between firms. The FRC should, therefore, promote the use a common reporting framework based on the agreed drivers. Such a framework will complement plans for enhanced information on the results of independent audit inspections carried out by the Audit Inspection Unit (AIU). The AIU would provide some degree of independent verification of the firms' claims.

The recommendation has been amended to emphasise that much of the responsibility for promoting greater transparency of firms' capabilities rests with the firms themselves.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without further amendment.

### Recommendation 5

**The FRC should continue its efforts to promote understanding of audit quality and the firms and the FRC should promote greater transparency of the capabilities of individual firms.**



## Recommendation 6: Reduced risk and cost of changing auditors

Background	Consultation responses
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>The Oxera study found that it was generally recognised by audit committee chairs, finance directors and audit firms that it takes time for a new audit team to develop a comprehensive understanding of a company's business.</li> <li>Several audit committee chairs commented to Oxera that the process of becoming familiar with the company can take up to two years, a period during which the company management will have to invest time in bringing the auditor up to speed.</li> <li>A variety of different arrangements occur in practice to facilitate the effective handover between the incoming and outgoing auditor. These include the exchange of letters, discussion between the incoming and outgoing auditors, the exchange of audit committee papers and minutes, and the shadowing of the outgoing auditor at key meetings such as the final audit committee meeting.</li> <li>It would however be extremely unusual for the outgoing auditor to share audit work papers with the incoming auditor due mainly to liability concerns. Firms also cite ethical issues and concerns over confidentiality of propriety audit methodologies.</li> </ul> <p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>Audit Committees perceive changing auditors to be costly and risky.</li> <li>The cost and risk associated with a change of auditors act as strong disincentives to changing auditors.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Information is more fully shared so as to reduce the perceived or actual cost and risk of changing auditors.</li> <li>Audit Committees perceive the cost and risk associated with changing auditors to be manageable.</li> <li>The cost and risk associated with a change of auditors do not act as strong disincentives to changing auditors.</li> </ul> <p><b>Provisional recommendation 6</b></p> <ul style="list-style-type: none"> <li>The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.</li> </ul>	<p><b>Effectiveness</b></p> <p>There was agreement that improving access by the incoming auditor to information relevant to the audit held by the outgoing auditor could reduce the perceived risk and cost of changing auditors.</p> <p>We believe that this is an area worth exploring, especially as one of the principal barriers to changing auditor which we see reported to us is the loss of knowledge and information. Any way in which this can effectively be mitigated should be explored. <i>Hermes</i></p> <p>One of the main barriers to changing auditors is the costs and risks associated with the change. It takes time for a new audit team to develop understanding of the company's business and this can cause disruption to the finance function of companies. [...] The regulations governing the conduct of the Audit firms should oblige them to support new auditors taking over their assignments by providing copies of the working papers and as much liaison and overlap as may reasonably be required by the new auditor and the client. <i>Rio Tinto</i></p> <p>It was suggested that the existing arrangements for handover between audit firms are satisfactory.</p> <p>We have recently completed a tender process for the provision of audit and tax services, and consequently consider ourselves reasonably informed as to the state and nature of the market for such services. [...] In our experience, there are no barriers between incoming and outgoing auditors on transition. <i>St Modwen Properties PLC</i></p> <p>It was noted that any new mechanism would need to the support of the companies involved, particularly for companies with listings outside of Europe.</p> <p>We would have thought that public entities are a key constituent for establishing such a mechanism from both the perspective of how they may be able to facilitate any such mechanism (if at all) and how they would be impacted. In principle, the Hundred Group is supportive of the idea but the practical application of such a mechanism would need to be supported by the public entity involved. <i>Hundred Group of Finance Directors</i></p> <p>In the case of major public interest entities with geographic interests and/or listings outside of the EU, particularly in the US, there are significant hurdles to overcome, and international co-operation is vital. <i>National Grid</i></p>

## Recommendation 6: Reduced risk and cost of changing auditors (ii)

### Consultation responses (continued)

#### Quality

There were mixed views on how improved access by the incoming auditor to information relevant to the audit held by the outgoing auditor would impact audit quality.

It appears entirely appropriate to increase access to the audit information held by the outgoing auditor. This would allow a smoother transition when changing firms and should raise audit quality in the period after change. *Amlin*

[...] the reason for appointing new auditors is to have a fresh approach to review and question a business without previous knowledge or pre-set assumptions and, therefore, requirements for access to information should be kept to the minimum required in the 8th Directive. *ICAS*

In terms of the handover of information from one firm to the other there should be agreed practices by which the new firm obtains familiarity with the key issues without full disclosure of details of judgements made by the outgoing firm - indeed it is important that the new firm arrives independently at its own judgements. *Aggreko*

#### Cost

It was noted that the new arrangements would need to avoid undue risks to firms.

We are happy to support the development of mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor, subject to an appropriate hold harmless arrangement in favour of the outgoing auditor and the payment of appropriate fees and expenses. *PricewaterhouseCoopers*

We support the stated objective as without this any change of auditor is more difficult. The litigation issue must be addressed as otherwise the recommendation can only be partially effective; similarly the revised EU Statutory Audit Directive requirement needs to be determined in practice. *Standard Chartered*

### Conclusions

Market participants generally support the development of mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.

It has been suggested that this would be achieved through implementation of the revised EU Statutory Audit Directive. The Directive has, however, been interpreted by some as only applying to information about the company, rather than information about the audit of the company. This recommendation was intended to help ensure that incoming auditors have access to *all* information that is relevant to the audit.

Incoming auditors will need to balance the use of information provided by their predecessors with the need to approach the audit independently. To facilitate sharing of audit files, the outgoing audit firms would want to be protected from litigation arising from both the reliance placed by the incoming auditor on the information provided to them and from the company in relation to sensitive information held on the file. The profession will need to establish a mechanism to facilitate such protection without affecting the outgoing auditor's responsibility in respect of opinions previously provided.

The Group was pleased to note that the Joint Audit Committee of ICAEW, ICAS and ICAI is now 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. It will be important for the bodies to consult public interest entities over the proposed new arrangements.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

### Recommendation 6

**The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.**

## Recommendation 7: Guidance on use of firms from more than one network

Current market characteristics	Background
<ul style="list-style-type: none"> <li>Most international audit firms (both the Big Four and the non-Big Four) are structured as networks of independently owned and operated firms. The Big Four firms are generally perceived to have more extensive and more integrated networks than non-Big Four firms, including branding, common audit methodologies and quality standards, knowledge sharing and governance arrangements.</li> <li>The Oxera study noted that companies generally prefer to have the same audit firm across the countries where they operate, or into which they are planning to expand. Having one audit firm was associated with lower levels of risk.</li> <li>There is a perception in the market that auditing standards discourage the use of auditors from more than one network. The revised and redrafted group auditing standard ISA 600 states that although other auditors may perform work on the financial information of components for the group audit, the group auditor alone is responsible for the audit opinion on the group financial statements. The ISA does not impose differing obligations on the group auditor when using the work of firms from other audit networks as compared to firms from within the auditor's own network. It does however recognise that this may be a relevant factor in determining the depth of the group auditor's understanding of the other auditor. This depth of understanding, together with the risk associated with the particular component, are factors in determining the extent and nature of the group auditor's involvement in the work performed by other firms.</li> </ul>	<p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>Audit committees are unlikely to consider using audit firms from more than one network.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Audit committees of growing companies using non-Big Four firms do not automatically appoint Big Four auditors when their activities expand geographically.</li> <li>Audit committees seek to appoint auditors for individual components of the group financial statements based on how best to achieve audit quality for that particular component and for the group as a whole.</li> </ul> <p><b>Provisional recommendation 7</b></p> <ul style="list-style-type: none"> <li>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 audit network.</li> </ul>

### Consultation responses

#### Effectiveness

There was support for guidance to improve awareness and understanding of choice options.

There may be circumstances in which it is appropriate to use firms from more than one network and thus independent guidance would be useful. *BDO Stoy Hayward*

We endorse the need for audit committees to be able to make decisions as to whether to use a single global network or not on a well-informed basis. We agree that, in principle, there is no reason why companies should not use firms from more than one network. CIMA therefore believes that this is a sensible recommendation in that it will improve information available to audit committees, while still giving them the freedom to make the decision that is best suited to their particular circumstances. *CIMA*

This is an important area since it goes to the heart of the debate about the benefits of an international network and the competitive advantage that may accrue dependent on the existence or quality of such a network. However, the consultation document rightly recognises that the use of different auditors for group and subsidiary accounts can be a way of introducing a second pair of eyes that may enhance audit quality. This approach therefore has potential benefits as well as likely additional costs. Audit committees need to take an informed view on this. *Association of British Insurers*

It was suggested that the guidance would have limited use particularly for the largest multinational groups.

We strongly believe that for companies of our size and complexity the costs and risks of appointing firms from more than one network significantly outweigh any benefits. For a large financial institution like ours, the independence rules are also a major barrier to employing more than one firm. We would also point out that some recent auditing failures have to a degree been blamed on the audit being undertaken by more than one firm. We see little merit in guidance on this issue; indeed it is difficult to see what form it would take. Companies must take their own decisions in the light of individual circumstances. *Royal Bank of Scotland*

It is highly unlikely in our view that companies would prefer to use firms from more than one network. This is because it adds to total audit and management's coordination time and to the complexity of the audit, with different teams taking extra time and effort to coordinate and assimilate their policies, procedures and work results into one audit. *Ernst & Young*

## Recommendation 7: Guidance on use of firms from more than one network (ii)

### Consultation responses (continued)

#### Quality

There was concern that the guidance could damage audit quality by promoting the use of firms from more than one network.

[...] it would be a retrograde step to promote the use of firms from more than one network. It is difficult enough for an audit committee to satisfy itself that it is getting a satisfactory level of service and challenge from a single firm without having to consider whether the co-ordination/co-operation between firms is sufficient to ensure sufficient audit quality, challenge, efficiency and value for money. In my view audits that involve more than one audit firm would run an increased risk of being bureaucratic and process driven with less emphasis on or consideration of principle and judgemental issues. *Professor Ewan Brown*

We believe the decision to use firms from one (international) network or more is wholly that of the using company. There may be, and usually are, good commercial and efficiency reasons for using one network and this should not be over-ridden by FRC guidance. Similarly, we believe that the use of joint auditors is a decision for the using company and not the market. *Aggreko*

There were mixed views on the appropriateness of the use of joint auditors.

We need to move from anecdotal comments on joint audits to a proper evidence-based assessment of their potential to address the issues dealt with by the MPG report together with an analysis of any obstacles to introducing them and how these may be overcome. A thorough independent study on joint audits should therefore be undertaken under the auspices of the FRC. The views of those with experience of joint audits should be carefully considered in the study. *Mazars*

We are not in favour of joint audit arrangements in that they either (or both) increase the risk of incorrect audit assessments (e.g. BCCI, Parmalat) or they increase costs as a consequence of requiring two audit firms to cover the same areas. However, we do believe that is appropriate for a primary auditor to be able to subcontract audit procedures in particular jurisdictions (extending their scale and geographical reach) or in particular areas of technical expertise, provided that they retain full responsibility for the audit opinion on the consolidated financial statements. *National Grid*

#### Cost

No additional comments.

### Conclusions

Responses were mixed. Many discussed the case for and against appointing auditors from more than one network rather than the particular merits of issuing independent guidance on the subject. The responses that commented specifically on guidance were broadly positive.

There were concerns that the guidance would promote the use of auditors from more than one network in circumstances where this could damage audit quality. Any guidance prepared by the FRC would thoroughly examine the costs and risks as well as possible advantages in different situations. It would recognise relevant regulation including ISA 600 and would be subject to consultation in accordance with the FRC's normal procedures.

The guidance would describe joint audits as one option amongst others for the use of firms from more than one network. A clear explanation of the features of joint audits and the advantages and disadvantages of the approach could be helpful as many market participants are not familiar with the approach. Although it is not expected that many companies would choose to appoint joint auditors, some might consider other arrangements for the selective use of firms from more than one network.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

### Recommendation 7

**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 audit network.**

## Recommendation 8: Communication between boards and shareholders on auditor selection

	Background	
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>▪ The Combined Code on Corporate Governance requires there to be a separate section in the annual report that describes the work of the audit committee in discharging its terms of reference. Some companies present this as a separate report; others include it as a section within their Corporate Governance report.</li> <li>▪ Most companies surveyed by Oxera put their audit out to tender at most once every five years. There are examples of companies having used the same audit firm for decades. While such arrangements might be entirely consistent with audit effectiveness, few audit committee reports describe in any detail the policy adopted by the audit committee on auditor tendering and switching.</li> <li>▪ Few annual reports describe in any detail the policy adopted by the audit committee on auditor tendering and switching or provide information on the company's tendering history.</li> </ul>		
<p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>▪ In the absence of information on the basis of the auditor appointment decision, investors tend not to discuss auditor selection with companies.</li> <li>▪ Without shareholder engagement, there is a risk that companies and audit committees may not fully consider how best to achieve audit quality through their auditor selection decisions.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>▪ Companies provide more information on auditor selection decisions as a basis for discussing auditor selection policy with shareholders.</li> </ul>		
<p><b>Provisional recommendation 8</b></p> <ul style="list-style-type: none"> <li>▪ The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.</li> </ul>		

### Consultation responses

#### Effectiveness

There was general support for amending the guidance to companies on communication with shareholders on auditor selection.

Current audit committee reporting is limited in the area of auditor selection which means that there is little basis on which shareholders can call them to account. We would welcome this changing as we believe that there can only be a benefit from encouraging a greater dialogue between audit committees and shareholders in general and on this vital decision in particular. *Hermes*

We would support the provision of information relevant to the auditor selection process, as called for in provisional recommendation 8, as we believe it would reduce a barrier to the more frequent tendering of audits which is essential if the extremely high level of concentration, even among FTSE Small Cap companies, is to be reduced. *Quoted Companies Alliance*

We agree in principle. Transparency in the process may encourage audit committees to consider a wider selection of auditors for tender. *ICAEW*

It was suggested that the provision of additional information needed to be carefully managed to as to avoid 'boilerplate' reporting and inertia.

IMA supports the FRC amending the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision. However, we are concerned in case this results in unhelpful, boilerplate disclosures and would welcome it being strengthened so that audit committees also make themselves available, if necessary, to explain to major shareholders any changes of auditor and if shareholders request, they should consult them on the selection of an alternative from a wider range of firms. *Investment Management Association*

We support this recommendation, noting for emphasis that the Smith Guidance is guidance as such and not a requirement. We recognise the comments in the consultation document that imply that companies generally provide insufficient information for investors to make an informed decision regarding auditor selection. However, we are concerned that the guidance will merely result in unhelpful boilerplate disclosures. Consideration should be given by the Group as to how this will be prevented. *Standard Life Investments*

Increasing shareholder involvement in the selection of an auditor is both impractical and undesirable (and in any event, investor groups and corporate governance agencies would likely have a strong inclination towards the safe harbour of a 'Big Four' auditor). *St Modwen Properties*

## Recommendation 8: Communication between boards and shareholders on auditor selection (ii)

### Consultation responses (continued)

#### Quality

It was suggested that further explanation of the basis of auditor appointment decisions could lead to increased focus on quality

We agree that greater transparency about audit selection would be useful. We believe it would be useful for audit committees to explain how they have assessed the effectiveness of their audit arrangements, and their perception of the quality of the audit. *BDO Stoy Hayward*

#### Cost

It was suggested that the provision of information to shareholders could lead to the expense of unnecessary audit tendering or increased use of Big Four firms.

We support the provisional recommendation for disclosure to provide greater transparency about auditor appointment decisions. However, we consider the disclosure should be in terms of policies rather than detailed specifics. While there may be a case for increased engagement with shareholders on audit appointments, we share the concerns noted by the Group that this could result in some pressure to put the audit out to tender at regular intervals even if the audit service is felt to be satisfactory. *Rio Tinto*

### Conclusions

Market participants generally agree that there is a need for improved communication with shareholders of information relevant to auditor selection. Primary responsibility for the selection of auditors and the frequency of tenders would remain with boards, but the information could form a useful basis for consultation with shareholders. Discussions could typically take place as part of the routine meetings between companies and shareholders.

The concerns raised in responses to this provisional recommendation, including the risk of 'boilerplate' reporting, excessive conservatism in auditor selection, and the cost of unnecessary audit tenders would need to be considered by the FRC during the development of proposed revisions to the Smith Guidance. Good practices for shareholder engagement on auditor appointments and reappointments, as envisaged under recommendation 10, should help to mitigate these risks.

In amending the Smith Guidance, consideration should be given to the need for an explanation of the decision to use firms from the same or different networks for different parts of a group audit (see recommendation 7).

Any proposed revisions to the Smith Guidance would be subject to consultation in accordance with the FRC's normal procedures.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

### Recommendation 8

The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.

## Recommendation 9: Requirements of banks and other advisers to use certain audit firms

	Background
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>Non-Big Four firms have provided examples of cases where advisers have recommended or required the use of a Big Four firm. In particular, banks may impose conditions prior to issuing loans, or as part of loan covenants.</li> <li>Some banking agreements include terms such as: "Auditors" means in relation to each Group Entity, one of the following firms: Deloitte &amp; Touche LLP, KPMG LLP, PricewaterhouseCoopers LLP or Ernst &amp; Young LLP, or any other firm of chartered accountants of internationally recognised standing that has been approved by the Agent and appointed as auditors of such Group Entity.</li> </ul> <p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>The non-Big Four believe this to be a factor limiting their opportunity to be considered by growing companies. One firm pointed out that for a public interest entity to decide to appoint a non-Big Four is often a challenge in itself, and it does not take much for the companies to revert back to their 'comfort zone'.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Where advisers do exert influence over auditor selection, this is based on a well-informed judgement of the appropriateness of different audit firms to the needs of their client.</li> <li>Where advisers exert influence the rationale for this is explained to the client.</li> </ul> <p><b>Provisional recommendation 9</b></p> <ul style="list-style-type: none"> <li>When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.</li> </ul>	

### Consultation responses

#### Effectiveness

There was support for disclosures of contractual obligations.

We consider that this could lead to a more open discussion over advice given and market pressure on the advisers or banks to change their position. *Investment Management Association*

We often hear our companies say that as they prepare for a public listing they are advised by their brokers that if their auditor is from outside the Big 4 they should switch to a Big 4 firm as this will increase confidence in their published figures. This view from some advisers appears to be based on their perceptions rather than the actual capabilities of the different firms *Quoted Companies Alliance*

It was suggested that banks do not routinely insist on the use of Big Four firms.

While we have no difficulty with the recommendation, we are not aware of it being prevalent market practice for banks or other corporate advisors to advise or insist upon clients using a Big Four firm. In case of established borrowers, lenders typically working with the borrower's existing auditors, which often will be one of the Big Four although by no means this is always the case. The situation differs slightly in case of leveraged loans, where the loan agreement may stipulate that an auditor of internationally recognised standing be used. *British Bankers Association*

It was suggested that the banks' policy on audit firm appointment could be addressed more directly.

We support the recommendation, but in addition we would support a recommendation for leading investment and commercial banks to disclose their policy on audit firm appointment; the recommendation for disclosure by issuers themselves should be restricted to contractual obligations. *Grant Thornton*

[...] the more important factor is not banks (or other advisers) "requiring" but in their "advising" (more or less formally) the use of a given type of firm, so exhortation must be addressed to the banks and other advisers. Accordingly, we urge the Market Participants Group to address directly the relevant banks (the number of banks directly involved with medium sized firms where the issue arises is small) and their representative bodies. This dialogue should advise bank officers not automatically to urge a switch to one of a selected group of audit firms, but to do so only after mature consideration of the specific contingencies applicable in the particular case. *Association of Corporate Treasurers*

A.2 Increased propensity for public interest entities to select non-Big Four firms as auditors

## Recommendation 9: Requirements of banks and other advisers to use certain audit firms (ii)

### Consultation responses (continued)

#### Quality

No comments received

#### Cost

It was suggested that there would be a need to avoid the expense of removing confidentiality clauses from existing contracts.

We support the principle of disclosure, however, there may need to be deminimis limits, and there are also occasions when commercial sensitivities (e.g. possible due diligence work which is confidential) preclude disclosure. ICAS

We agree with MPG's positions on this recommendation. However, we should add that this would include changes in terms of reference for most advisors and bankers to waive confidentiality of contractual terms such as the identity of the audit firm.  
*Ernst & Young*

#### Conclusions

Market participants generally support the principle that contractual obligations to use certain audit firms should be transparent.

The Group believed that it would be undesirable to restrict how banks and other advisers advise their clients. Other recommendations in this report (e.g. 2, 4 and 5) should result in corporate advisers becoming better informed on the capabilities of the different audit firms.

Although it is reasonable for lenders to wish to be assured that a suitable auditor is appointed and to refer, for example, to 'firms of internationally recognised standing', it is undesirable that standard wording for banking agreements should name particular firms.

It is envisaged that this recommendation would be implemented using a change to the Smith Guidance. The confidentiality issues would need to be considered during the development of proposed revisions to the Smith Guidance, which would be subject to consultation by the FRC in accordance with its normal procedures.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

#### Recommendation 9

**When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.**



## Recommendation 10: Shareholder engagement on auditor selection

<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>There is only very limited direct communication between companies and investors regarding auditor selection. Audit committees and company management tend to assume that shareholders prefer Big Four firms.</li> <li>The Investment Committee of the Association of British Insurers released a statement in June 2006 encouraging companies to have an open mind and consider all choices when appointing auditors. A group of six investment management organisations wrote to audit committees along similar lines.</li> <li>Shareholders vote on the reappointment of auditors each year but it is very rare for there to be any discussion between investors and companies over the reappointment decision.</li> </ul>	<p><b>Background</b></p>	<p><b>Effectiveness</b></p> <p>There was general support for steps to improve contact between shareholders and companies over auditor selection in order to avoid misunderstandings.</p> <p>Dialogue with audit committees is one aspect of responsible shareholder engagement with boards. In practice such engagement has been relatively limited in extent and we consider it desirable that encouragement be given to increasing its prevalence. However, we would not think it helpful to prescribe the nature or scope of such discussions. Broadly speaking we see existing guidance within the Combined Code, complemented by that produced by other bodies such as the Institutional Shareholders' Committee focusing on the responsibilities of shareholders, as being sufficient. However, all parties should keep such matters under review. <i>Association of British Insurers</i></p> <p>Agreed. It has become evident during the course of the current debate on Competition and Choice that directors, particularly non executive directors and members of audit committees, believe that investors have a more restrictive view on the appropriateness of audit firms than is the case. <i>BDO Stoy Hayward</i></p> <p>There were mixed views on the shareholder vote on audit committee reports with most respondents opposed to further consideration of the option at this stage.</p>	<p><b>Consultation responses</b></p>
<p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>Audit committees and company management seek to prevent criticism by shareholders of their audit selection decision by hiring a Big Four firm – the 'IBM effect'.</li> <li>Shareholders tend to assume that there is no need to pay particular attention to companies' auditor selection policies and decisions other than in exceptional circumstances.</li> </ul>		<p>[...] the commentary on and the evaluation of the provisional recommendation, as set out in the Consultation Document, fails to recognise the wider and very significant adverse consequences of a shareholder vote on audit committee report for corporate governance in the UK. In particular, such a vote could undermine the unitary board responsibility for the financial aspects of corporate governance. Also, the risks of destabilising the well-balanced and well-respected corporate governance environment which exists in the UK by having such a vote should not be underestimated. <i>Standard Life Investments</i></p> <p>As regards having a vote on audit committee reports, we are not at this stage convinced that this will enhance choice in the audit market. If there is to be a vote, it should be on the specific issue of the information referred to in Recommendation 8 rather than on other aspects of the report on the way the audit committee has discharged its responsibilities. <i>ICAEW</i></p> <p>We have previously commented that there is merit in putting the audit committee report to a vote and remain of that view. <i>NAPF</i></p>	
<p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Investors engage with companies over auditor selection policies and decisions.</li> <li>Audit committees and company management take appropriate account of the views of their shareholders on auditor selection policies and decisions.</li> </ul>			
<p><b>Provisional recommendation 10</b></p> <ul style="list-style-type: none"> <li>Investor groups, corporate representatives and the FRC should develop good practices for shareholder engagement on auditor appointment and re-appointments and should consider the option of having a shareholder vote on audit committee reports.</li> </ul>			

A.2 Increased propensity for public interest entities to select non-Big Four firms as auditors

## Recommendation 10: Shareholder engagement on auditor selection (ii)

### Consultation responses (continued)

#### Effectiveness (continued)

It was suggested that special consideration was needed for how smaller listed companies could engage with shareholders.

It will be important, however, to consider the practical challenges of making this work for companies outside the FTSE 350 as a number already find it difficult to have significant contact with their major institutional shareholders due to limited resources at the institutions most of which is focussed on FTSE 350 companies. *Quoted Companies Alliance*

#### Quality

There was some concern that 'unnecessary' audit tenders could have a detrimental effect on audit quality.

We firmly believe that decisions on the choice of auditors should reside with the board and do not believe that the best interests of the UK companies are served by enforced rotation of audit firms. We are therefore opposed to recommendation 10 that the FRC considers the option of shareholders being given the right to vote on audit committee reports. We are concerned that audit committees might feel the need to put audits out to tender in order to be seen to be acting responsibly even though this may be sub optimal. If such a vote were to be binding on the company it could lead to a requirement to put an audit out to tender at considerable expense to the company and with a detrimental effect on audit quality. *Associated British Foods*

Since the auditor's ultimate responsibility is to produce a report to the shareholders, we are supportive of appropriate shareholder engagement on the audit appointment and re-appointment process. However, this must not be at the expense of the responsibilities of the Board, nor must it end up in a situation where shareholders, with inevitably less detailed knowledge of the group, its systems, controls and people, override the judgements and decisions of the audit committee. If investors do not have confidence in the decisions of the audit committee and the Board, their remedy is to change the Board, not the decisions made by the directors for the time being. The FRC have rightly stressed that no recommendation should be put in place which might reduce audit quality - this is an area where there is such a risk unless great care is taken. *PricewaterhouseCoopers*

#### Cost

No additional comments made.

### Conclusions

Market participants generally agree that there should be improved shareholder engagement on auditor selection. They do not support, however, taking forward a shareholder vote on audit committee reports, at least until other options had been fully explored. The recommendation has therefore been redrafted to remove specific reference to a vote.

The recommendation has also been amended to suggest that good practices are 'promoted' rather than 'developed', to better reflect the existing guidance that is available. In addition auditors have been added to the group of market participants who would promote the good practices.

It will be important that those implementing this recommendation consider how to mitigate the risk that audit committees put audits out to tender without good reason. Similarly, differences between FTSE 350 and other listed companies in how they engage with shareholders could be a relevant consideration.

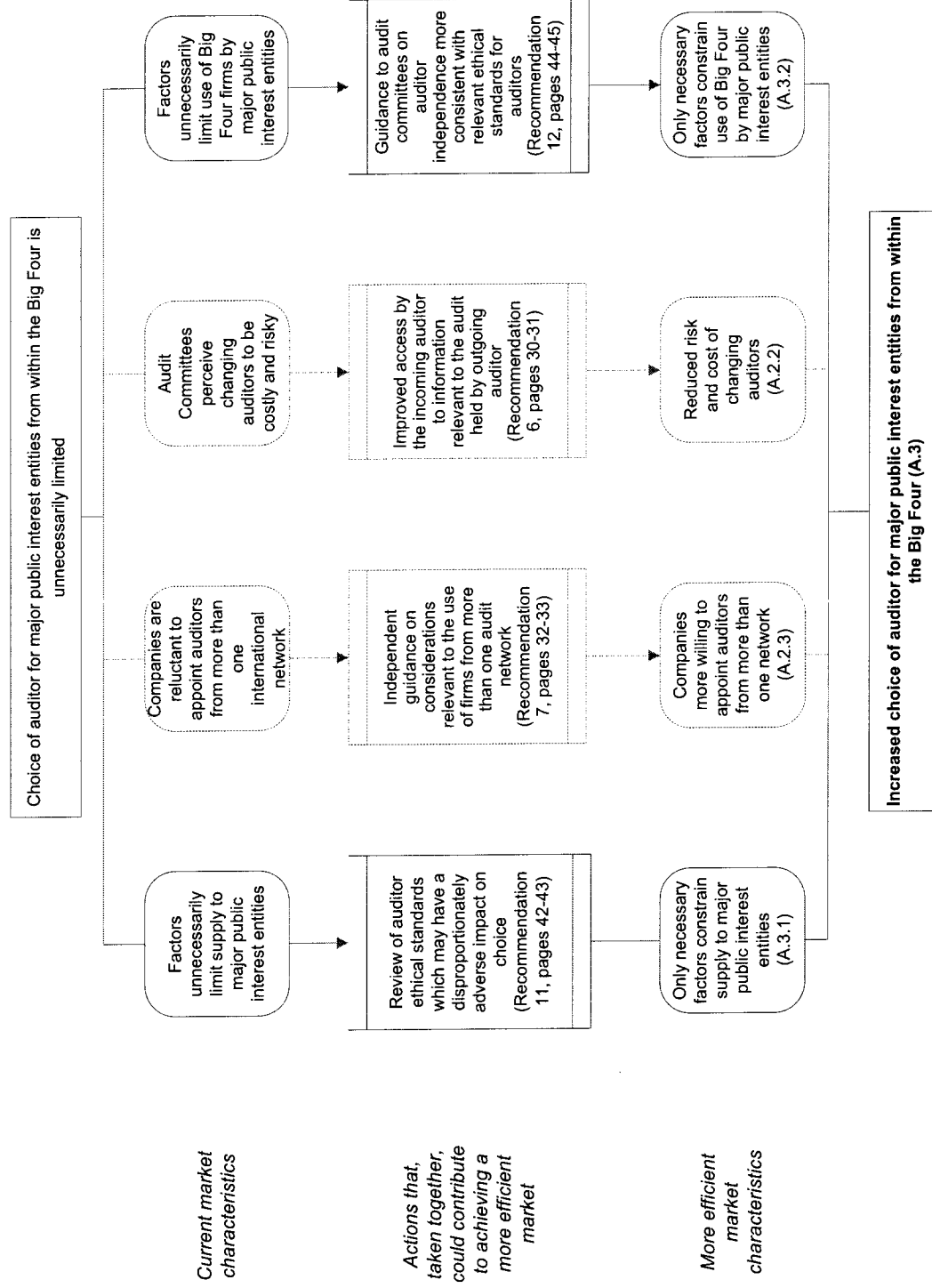
On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without further amendment.

### Recommendation 10

**Investor groups, corporate representatives, auditors and the FRC should promote good practices for shareholder engagement on auditor appointments and re-appointments.**

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## A.3 Increased choice of auditor for major public interest entities from within the Big Four - Summary



## A.3 Increased choice of auditor for major public interest entities from within the Big Four Recommendation 11: Ethical standards for auditors

	Consultation responses
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>Auditors are required to conduct audits with integrity, objectivity and independence. Standards and guidelines issued by the Auditing Practices Board in the UK include specific circumstances arising out of the financial, business, employment and personal relationships with the audit client; long association with the audit engagement; and non-audit services provided to audit clients.</li> <li>The U.S. SEC rules in these areas are generally more prescriptive than UK rules or those of the International Federation of Accountants, particularly in the area of financial and business relationships with the audit client. For example audit team members can hold bank accounts with audit clients under both APB and SEC rules, but the SEC rules limit the accounts to those with balances below government insured limits, with the implications of this varying across the different countries in which audit team members hold the accounts.</li> </ul> <p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>US independence rules impact directly on UK companies that are listed in the US and may apply more widely as firms, when developing an international approach to independence, standardise on the most prescriptive (i.e. U.S.) requirements on a global basis. The rules can make auditor changes for financial institutions particularly difficult.</li> <li>There are concerns that ethical standards, particularly those of the US SEC, are causing an adverse impact on choice that is disproportionate to the benefits to auditor objectivity and independence. Some are concerned that the UK rules requiring audit partners for listed companies to be related every five years could act as a disincentive for companies to change auditors, because there is a need to consider not only the audit partner proposed for an audit but also the firm's ability to find a replacement partner in five years' time.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>Auditor independence rules are set at the level necessary to protect audit quality hence avoiding unnecessary constraints on audit choice.</li> <li>Auditor independence rules are generally consistent in major markets.</li> </ul> <p><b>Provisional recommendation 12</b></p> <ul style="list-style-type: none"> <li>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.</li> </ul>	<p><b>Effectiveness</b></p> <p>There was general agreement that the impact on auditor choice should be considered by those setting or reviewing auditor independence rules.</p> <p>Agreed. Auditor independence is an important means to an end of high audit quality but it is not an end in itself. Regulators (nationally and internationally) should, going forward, take into account the consequences for market choice of prescriptive rules on independence, when a more principles-based threats and safeguards approach could ensure independence while preserving flexibility. <i>ICAEW</i></p> <p>We agree with the assessment of the provisional recommendation. ACCA has been consistently of the view the wider public interest has to be recognised when setting standards for independence and objectivity. There are many matters of public interest that authorities should consider when establishing ethical standards for auditors and we agree that the impact on auditor choice should be considered. <i>ACCA</i></p> <p>Yes. Independence considerations are a significant barrier to choice of other Big 4 firms. Simplifying rules in this area (whether completely, or through allowing appropriate "transition" periods) would enable more firms to be able to compete for assignments requiring independence - at the moment the choice can be effectively be limited to one alternative firm only. [...] Although there are some services (eg management services) that are incompatible with auditor independence, there are many others that are restricted by different regulators for similar reasons, but slightly different conclusions. We believe a much simpler, and most importantly, single international set of rules would improve access of companies to Big Four firms. <i>National Grid</i></p> <p>It was suggested that audit choice is not a relevant consideration in independence rules.</p> <p>We support clear guidance for firms on independence which should be established without regard to choice in the audit market. We are subject to the US Securities and Exchange Commission's rules on independence and whilst onerous we see them as workable. We would certainly welcome some convergence on independence rules globally. <i>Royal Bank of Scotland</i></p> <p>It was suggested that there is no need to review auditor independence rules.</p> <p>It is appropriate to keep these matters in balance but I can see no persuasive argument for a change in the current arrangements. <i>Peter Smith</i></p>

A.3 Increased choice of auditor for major public interest entities from within the Big Four

## Recommendation 11: Ethical standards for auditors (ii)

### Consultation responses (continued)

#### *Effectiveness (continued)*

There were mixed views on the effects on audit choice of changing independence rules in the UK.

We would support the suggestion that a five-year rotation period for the lead audit partner is stricter than necessary and would support its relaxation to seven years. We believe that this would potentially increase the capability of non-Big Four firms to audit larger public interest entities as many of these entities have expressed concern about the need to assess not only the audit partner but her/his potential successor given the short time period for which someone can be lead audit partner. We do not believe this would have an adverse effect on audit quality, indeed it is more likely that it will increase audit quality. *BDO Stoy Hayward*

Whilst we do not have a problem with the specific suggestion to consider whether, in certain circumstances, the rotation period should be relaxed from 5 to 7 years, care needs to be taken to assess carefully the impact of any more general review that allowed auditors to undertake more non-audit work than is currently considered appropriate. From a competitive perspective, as discussed above, it is by undertaking non-audit work that leading firms outside the Big Four are most likely to establish a relationship with large listed companies and to build their credibility with them. *Mazars*

#### **Quality**

There were also mixed views on the effect of changing independence rules on audit quality.

The rules on auditor independence do limit the choice that large companies have. The constraints are particularly severe for SEC registrants. The current rules are unnecessarily burdensome and place heavy limitations on the choices available to companies seeking both audit and non-audit services. We would suggest that these rules could be relaxed considerably without impairing audit quality. The restrictions should be confined to those that are truly necessary and effective in protecting auditor independence. *Rio Tinto*

We support this recommendation in principle as well as the underlying objective of avoiding a disproportionately adverse impact on auditor choice. However, we emphasise our view that we are opposed to any weakening of the ethical standards expected of auditors and we are not ourselves aware of any rules that could have a disproportionately adverse impact on auditor choice. *Association of British Insurers*

#### **Cost**

No comments made.

### **Conclusions**

There was general agreement that those setting or reviewing ethical standards for auditors should have regard to the effect of the rules on audit choice. This is not to suggest that Choice should outweigh other factors, but it would be inappropriate for regulation to be set without consideration of possible deleterious impact on the market.

Only a limited number of ethical standards, or aspects of them, are likely to have a significant impact on Choice. Areas suggested include SEC rules governing personal lending and savings accounts with banking clients and moving the lead audit partner rotation period from 5 years to 7 years.

As noted in the Interim Report, the Auditing Practices Board (APB) is undertaking a review of ethical standards. The APB's priority is to achieve high standards in auditing but it also has a commitment to ensure that the costs of any of its standards is proportionate to the benefits. In so doing it will have regard to the views raised in this debate on particular ethical standards. Any proposals for change will be subject to consultation in accordance with the FRC's normal procedures.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

### **Recommendation 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.**

## Recommendation 12: Review of Independence section of Smith Guidance

Background	
<b>Current market characteristics</b>	<ul style="list-style-type: none"> <li>Many companies which use a Big Four firm as auditor also choose to use other Big Four firms for non-audit work.</li> <li>The Smith Guidance on Audit Committees guidance suggests that the audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The Guidance requires the audit committee to ensure that there is no threat to auditor objectivity and independence.</li> <li>The standards and guidance of the Auditing Practices Board (APB) describe how appropriate safeguards can be put in place to mitigate the risks to auditor objectivity and independence from the provision of non-audit services by the auditor.</li> </ul>
<b>Effects of current market characteristics</b>	<ul style="list-style-type: none"> <li>Some Boards adopt policies on the provision of non-audit services by the auditor that are more conservative than those suggested as necessary by the APB guidance. This can make it more difficult for the firms used for non-audit work to be considered for audit work.</li> <li>Some audit committees may have developed more conservative policies because they consider them appropriate, whereas others may have done so only because they believe them necessary to meet the Smith Guidance.</li> </ul>
<b>Characteristics of a more efficient market</b>	<ul style="list-style-type: none"> <li>In developing policy on the provision of non-audit services by the auditor, audit committees have clear guidance that is consistent with the guidance issued to the audit firms.</li> </ul>
<b>Provisional recommendation 12</b>	<ul style="list-style-type: none"> <li>The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.</li> </ul>

### Consultation responses

#### Effectiveness

There was general agreement that the Independence section of the Smith Guidance should be reviewed so as to avoid any unnecessary constraints on the choice of audit firms available to major public interest entities.

Agreed. We do not believe that the Smith Guidance as written was intended to be more prescriptive than the APB Ethical Standards but the 'black and white' wording in some areas (for example relationships) could be seen not to permit the application of safeguards. *ICAEW*

We would welcome work being done to ensure that the Smith Guidance on independence is consistent with ethical standards for auditors such that they do not impose further limitations on competition and perhaps therefore on quality. *Hermes*

We support this recommendation. However, it will be up to individual audit committees to decide to what extent they relax their policies on the provision of non audit work. *Royal Bank of Scotland*

It was suggested that the impact on audit committees of changing Smith needs more research.

We do not believe that there is such a great mismatch between what the Smith guidance and the Ethical Standards for auditors say on independence. The language in each is different, the Smith guidance being perhaps more black and white than the Ethical Standards, which allow for grey areas where judgement is required on threats and safeguards. We think the FRC might undertake some research with audit committees to see whether they are actually interpreting the Smith guidance differently from the way independence is phrased in the Ethical Standards for auditors or whether they are deliberately imposing black and white rules for their own convenience which are more stringent than either the Smith guidance or the Ethical Standards would require. *Herbert Smith*

## Recommendation 12: Review of Independence section of Smith Guidance (ii)

### Consultation responses (continued)

#### Quality

It was noted that the role of the Smith Guidance should be to inform audit committees on how best to protect auditor independence, rather than being seen as a compliance-based code.

Agreed. As noted above, we believe that a review would be sensible but note the importance of audit independence as a contributor to perceptions of audit quality. Given the current market concentration it is possible that a relaxation in certain regulations might reduce the pressure for the continual improvement of audit quality.  
*BDO Stoy Hayward*

It is important that audit committees should have oversight of this and be able to make their own judgements. The Smith Guidance, whether revised or not, should exist to support them in their role and should not be seen as a compliance-based code that prompts a favourable view merely because the matter does not contravene the APB's guidance. We are concerned at the implicit suggestion in this question that there might be some weakening of the requirements regarding independence and of the scope of audit committees to take an adverse view in circumstances where this seems the right course. *Association of British Insurers*

#### Cost

No comments made.

### Conclusions

Market participants generally agree that the two related sets of guidance on auditor independence should be more closely aligned. This would leave audit committees to consider whether the independence requirements of the Auditing Practices Board are sufficient to protect audit quality or whether further steps are necessary. If this did result in some Boards changing their policies, they would be accountable for this decision to investors who could discuss any concerns.

Any proposed revisions, to the Smith Guidance would be subject to consultation by the FRC in accordance with its normal procedures. Revisions should be in the form of clarifications of the guidance rather than any lessening of the need to achieve auditor independence.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

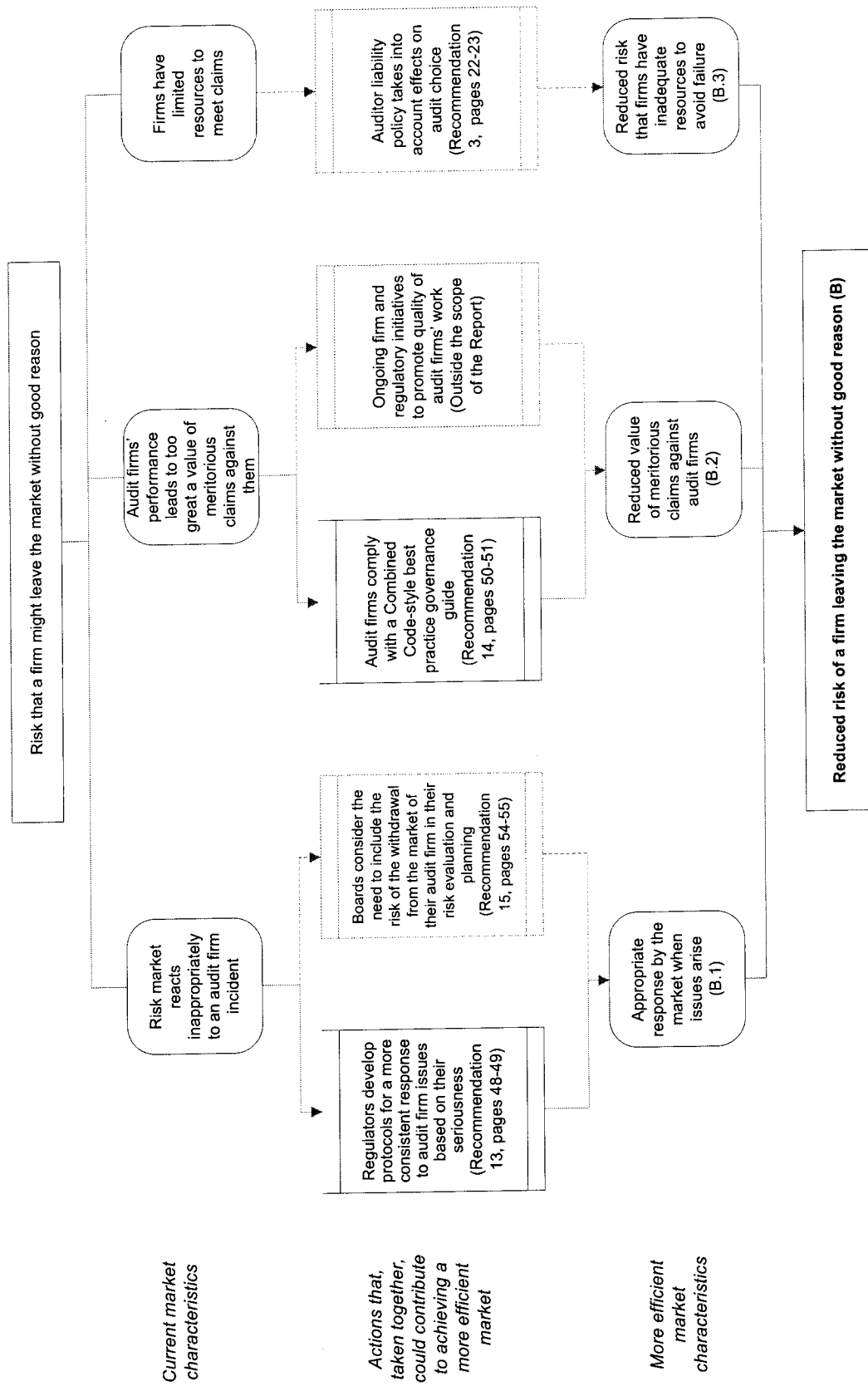
### Recommendation 12

**The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.**





## Summary for Objective B: Reduced risk of a firm leaving the market without good reason



B: Reduced risk of a firm leaving the market without good reason

## Recommendation 13: Protocols for regulatory response to audit firm issues

	Consultation responses
<div data-bbox="316 1476 339 1617">Background</div> <div data-bbox="370 1680 391 1997">Current market characteristics</div> <ul style="list-style-type: none"> <li>When there is a suggestion of possible misconduct by an audit firm, or there are other issues affecting an audit firm, companies are likely to consider how seriously regulators will take the issue before deciding how to respond themselves.</li> <li>In general, the responses to rule breaches are difficult to predict. In the UK, the Accountancy Investigation &amp; Discipline Board is the independent, investigative and disciplinary body for accountants in the UK. A Disciplinary Tribunal can impose fines against individual accountants or their firms as it considers appropriate or can remove auditing licences.</li> <li>Global regulators of the audit firms have various approaches to responding to rule breaches by audit firms.</li> </ul> <div data-bbox="792 1572 813 1990">Effects of current market characteristics</div> <ul style="list-style-type: none"> <li>The regulatory penalties on an audit network in response to rule breaches can be difficult to predict. This can lead to uncertainty over the fate of a firm that could be more damaging than the eventual penalties themselves.</li> </ul> <div data-bbox="959 1558 980 1990">Characteristics of a more efficient market</div> <ul style="list-style-type: none"> <li>The market reacts to audit firm issues with as much information as possible, including a reasonable level of clarity over any likely regulatory response.</li> <li>The market response could be based on a high-level description of the types of misconduct issues that might attract different types of regulatory responses. For example, how regulators would differentiate between an isolated issue in one office of a firm compared to a more systematic failure.</li> </ul> <div data-bbox="1239 1654 1260 1990">Provisional recommendation 13</div> <ul style="list-style-type: none"> <li>Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.</li> </ul>	<div data-bbox="329 905 350 1045">Effectiveness</div> <p>There was general support for steps to help achieve an appropriate response by the market when issues arise by reducing uncertainty over likely regulatory responses</p> <p>Currently, in the event of misconduct or breaches by an audit firm, companies may wait to see how regulators respond to the issue and, indeed how other companies react, before committing themselves to a change of auditor. This can lead to a period of uncertainty. We agree that it would be helpful if regulators were to establish clearly understood protocols, if possible global, which dealt with possible audit firm issues. There should be sensible, proportionate and timely reactions to rule breaches and the market should be kept informed during the process. Efforts should be made by regulators to understand as soon as possible whether the incident is an isolated breach or symptomatic of a wider malaise in the firm involved. <i>Rio Tinto</i></p> <p>Regardless of the size of the audit firm, we agree that speculation about what a regulatory penalty might be is likely of itself to have far worse consequences than the eventual penalty itself (if there is one). Any reasonable measures to reduce this possibility are welcome. <i>ICAEW</i></p> <p>The key to audit monitoring and, where necessary, improving audit practices, rests upon effective cooperation between the profession and the regulator, and this can only be accomplished if the regulator responds in a consistent manner. We would prefer any regulatory measures to be based on clear, publicly available protocols which should be based on the better regulation principles espoused in the McCrory Review of Regulatory Penalties. <i>ICAS</i></p> <p>Some responses argued that it was unrealistic to take steps to ensure greater consistency over responses to events that cannot be accurately predicted.</p> <p>We are not persuaded that any apparent inconsistency in the response of regulators to audit firm issues necessarily requires any action. By their nature, such issues and the surrounding circumstances are unique to each case. We are not aware of any work that has been undertaken comparing the response of regulators to different instances of rule breaches or misconduct. Furthermore, we see no genuine prospect of achieving consistency across jurisdictions; local regulators and legislators are unlikely to give up their power to set penalties and sanctions. <i>Royal Bank of Scotland</i></p> <p>We consider it important that regulators should be empowered to exercise their judgement over what will be difficult decisions in circumstances that cannot be foreseen in detail. There is therefore a danger that seeking to tie regulators down to acting in accordance with 'protocols' will reduce their room for manoeuvre. <i>Association of British Insurers</i></p>

B: Reduced risk of a firm leaving the market without good reason

## **Recommendation 13: Protocols for regulatory response to audit firm issues (ii)**

### **Consultation responses (continued)**

#### ***Effectiveness (continued)***

It was suggested that some form of 'administration' arrangement could be developed by regulators.

[...] while we recognise that this area is unlikely ever to be completely aligned internationally due to the inherently different legal frameworks and regulatory and judicial approaches, we consider that some form of coordinated international approach might be possible. One approach might be to establish some form of administration or "Chapter 11" type arrangement which would allow a firm to continue, perhaps under regulatory supervision, while the "market-withdrawal issue" is addressed. *National Grid*

#### ***Quality***

It was suggested that regulatory protocols could reinforce a notion that firms are too big to fail.

We support the provisional recommendation but in the interests of protecting audit quality it is vital that the protocols developed by regulators should recognise that situations may arise when very serious issues may necessitate a regulatory response which would call into question the sustainability of the audit firm in question and its ability to continue to provide audit services. *Standard Life Investments*

#### ***Cost***

No comments made

### **Conclusions**

Market participants generally agree that, in the long term, the response of regulators to audit firm issues of differing degrees of seriousness should be more predictable. Firms would still have the primary responsibility for ensuring that the market responds to an issue affecting them with full information but they would be assisted by clearer information from regulators.

The intention is not to take power away from individual regulators or legislators but instead to provide a practical framework within which penalties and sanctions could be considered. Regulators might, for example, differentiate more clearly between an isolated issue in one office of a firm compared to a more systematic failure.

Once individual regulators have considered such frameworks this could form a useful basis for international cooperation and, eventually, a protocol to support consistency across regulators.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

#### **Recommendation 13**

**Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.**

B: Reduced risk of a firm leaving the market without good reason

## Recommendation 14: Corporate governance of audit firms

Background	
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>Audit firms seek to avoid meritorious claims being made against them by delivering high quality audit and other services. The governance arrangements of audit firms contribute to the quality of the these services. The firms describe these arrangements in their annual reports.</li> <li>The UK's market-based approach to the regulation of corporate governance is based primarily on the Combined Code on Corporate Governance. The FSA's listing rules require companies to 'comply or explain' with the Code. The assessment of whether the company's governance practices are effective is made by the intended beneficiaries i.e. the shareholders. As partnerships, the UK audit firms do not have external shareholders and therefore are not required to 'comply or explain' with the Combined Code.</li> <li>The firms typically have partners who are not part of the firm's senior management who act as non-executive members of their Boards. Although they are not external directors these partners do have their personal capital, reputation and future income at risk.</li> </ul> <p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>Audit firms may not benefit to the full extent possible from relevant good governance practices identified in the Combined Code, including the external perspective of independent directors free of relationships or circumstances which are likely to affect, or could appear to effect, the director's judgement.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>The governance of the audit firms takes full account of relevant good governance practices identified in the Combined Code.</li> <li>Beneficiaries of audit services, including audit committees and shareholders, have information on which to assess the firms' governance practices.</li> </ul> <p><b>Provisional recommendation 14</b></p> <ul style="list-style-type: none"> <li>Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.</li> </ul>	<p><b>Effectiveness</b></p> <p>There was support for the principle of audit firms demonstrating more clearly there adherence to relevant best practices in corporate governance.</p> <p>The business of an audit firm has a major public interest perspective and the case for transparency is higher than it would be on other grounds. Notwithstanding that these firms are not themselves listed companies with a need to report to their own shareholders in this way there is a strong case for requiring a level of transparency and disclosure required of listed companies including relevant aspects of risk management. Compliance with the Code, or with analogous tailored provisions, has become seen as a mark of adherence to best practice in a number of non-listed company contexts, for example larger mutual insurance companies. <i>Association of British Insurers</i></p> <p>Similar benefits that have accrued to listed companies from compliance should manifest themselves within the firms. <i>Amlin</i></p> <p>There is a need for transparency by audit firms, so as to engender confidence in them and their statutory role. <i>Hermes</i></p> <p>It was suggested that the the firms' governance is already subject to sufficient regulatory oversight.</p> <p>Existing audit regulations and professional ethical requirements already require audit firms to operate to high professional standards. In fact, regulatory inspections already mean that these are already much stronger than the Combined Code on Corporate Governance. If there is considered to be a gap in audit regulations then we recommend that this is addressed as part of the regulatory framework for audit firms rather than creating multiple regulatory frameworks for audit firms to follow. <i>National Grid</i></p> <p>The firms have existing quality control and audit oversight procedures and it on these that they should concentrate their efforts. <i>Royal Bank of Scotland</i></p>

## Consultation responses

### Effectiveness

There was support for the principle of audit firms demonstrating more clearly there adherence to relevant best practices in corporate governance.

The business of an audit firm has a major public interest perspective and the case for transparency is higher than it would be on other grounds. Notwithstanding that these firms are not themselves listed companies with a need to report to their own shareholders in this way there is a strong case for requiring a level of transparency and disclosure required of listed companies including relevant aspects of risk management. Compliance with the Code, or with analogous tailored provisions, has become seen as a mark of adherence to best practice in a number of non-listed company contexts, for example larger mutual insurance companies. *Association of British Insurers*

Similar benefits that have accrued to listed companies from compliance should manifest themselves within the firms. *Amlin*

There is a need for transparency by audit firms, so as to engender confidence in them and their statutory role. *Hermes*

It was suggested that the the firms' governance is already subject to sufficient regulatory oversight.

Existing audit regulations and professional ethical requirements already require audit firms to operate to high professional standards. In fact, regulatory inspections already mean that these are already much stronger than the Combined Code on Corporate Governance. If there is considered to be a gap in audit regulations then we recommend that this is addressed as part of the regulatory framework for audit firms rather than creating multiple regulatory frameworks for audit firms to follow. *National Grid*

The firms have existing quality control and audit oversight procedures and it on these that they should concentrate their efforts. *Royal Bank of Scotland*

B: Reduced risk of a firm leaving the market without good reason

## Recommendation 14: Corporate governance of audit firms

### Consultation responses (continued)

#### Effectiveness (continued)

There was general agreement that the Combined Code for Corporate Governance would need adaptation if it were to be used by audit firms.

[...] the Combined Code sets standards and structures for the transparency of listed companies to their owners; these standards and structures are therefore not in any way appropriate to private partnerships. We do the Combined Code a disservice if we expect it to extend across such a range of organisations. *Hermes*

Whilst some of the provisions of the Combined Code will be directly applicable, many will not. This is because the Combined Code was developed to provide shareholders of listed entities, who are not directly involved in the management of the entity, with increased transparency on the operations of the board. Many of the recommendations in the Combined Code would not apply to the governance structures of audit firms where they are principally managed by the owners. *KPMG*

There were mixed views on the relevance of the Combined Code guidance on the use of non-executive directors.

[...] we believe that the introduction of non-executive directors to audit firms would be a welcome development and reinforce the importance of audit firms as key public interest entities. *CIMA*

There is one point of detail referred to in the Market Participants Group Report with which we fundamentally disagree, namely, the suggestion that because the members of our Supervisory Board are partners in our firm they lack "the expertise and independent challenge that comes from independent non-executive directors and strong, independent audit and remuneration committees". Partners in a firm such as PwC have very considerable expertise - indeed, we run courses for non-executive directors - as well as dealing on a daily basis with boards, committees and individual directors. Equally, it is a fundamental part of being a professional to make independent challenge when it is appropriate to do so. [...] Partners in PwC not only depend on the firm for their livelihood, but have invested in it their capital and their reputation. No one has a greater interest in ensuring good governance within the firm than the partners, and it is they who are best placed to make sure that the firm is indeed well managed and well governed. *PricewaterhouseCoopers*

#### Quality / Cost

No additional comments made

### Conclusions

Market participants generally agree that that firms should comply with a Combined Code-style best practice corporate governance guide or give a considered explanation, in order to reduce the risk of a firm leaving the market.

Existing regulatory activities (registration and inspection) are focused on audit quality rather than the firms' governance. If through a suitable 'comply or explain' arrangement there can be increased transparency over the firms' corporate governance arrangements this should be less costly than increased regulation.

The principles in the Combined Code are likely still to be relevant but would require modification to fit with the legal form and operating structures of audit firms.

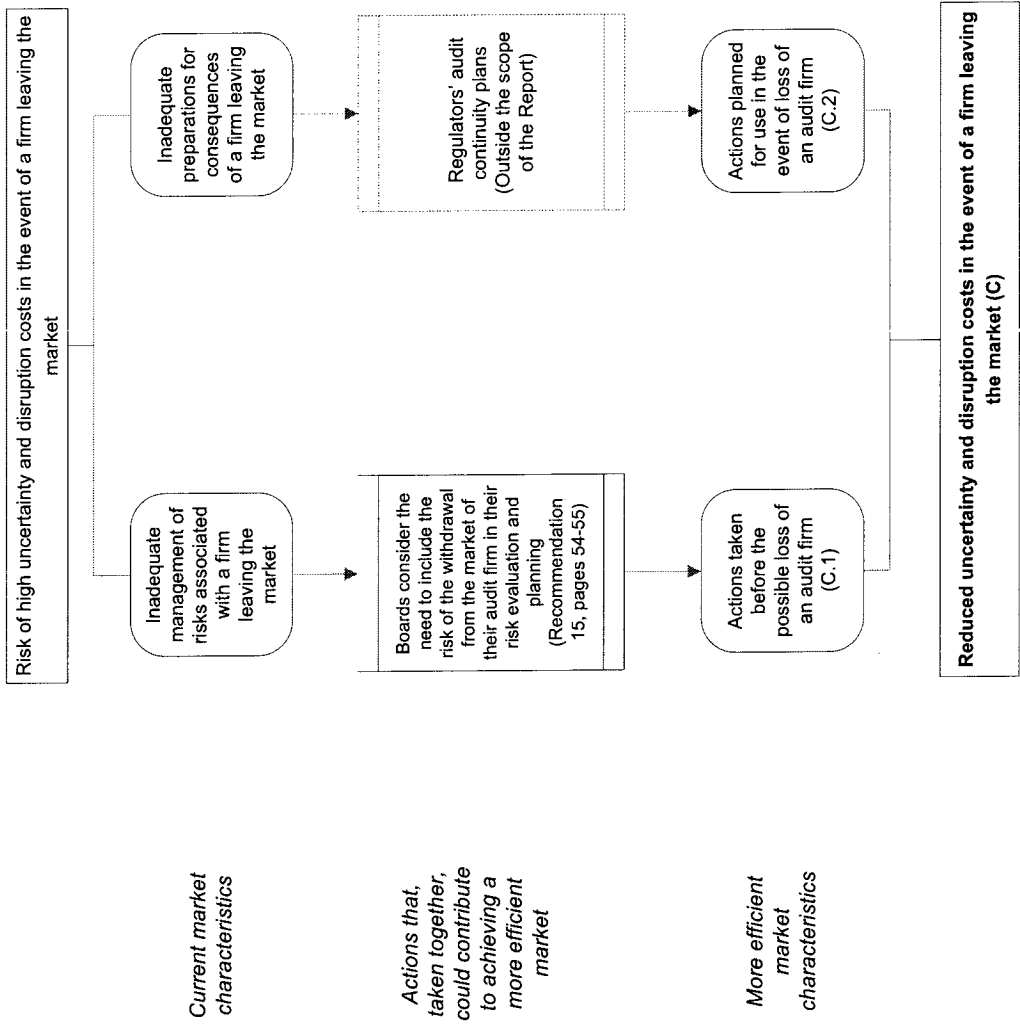
On this basis, having considered the consultation responses, the Group revised the provisional recommendation to refer to a Combined Code-style best practice corporate governance guide.

### Recommendation 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.**



Summary for Objective C: Reduced uncertainty and disruption costs in the event of a firm leaving the market





C: Reduced uncertainty and disruption costs in the event of a firm leaving the market

## Recommendation 15: Planning by companies for risk of their audit firm leaving the market

	Background
<p><b>Current market characteristics</b></p> <ul style="list-style-type: none"> <li>▪ The Turnbull Guidance requires boards to consider significant risks to the company achieving its business objectives and how they have been identified, evaluated and managed. The audit committee is responsible for monitoring the company's internal controls and risk management.</li> <li>▪ Some companies already identify the risk of the withdrawal of their audit firm from the market as a risk. Others may not have considered doing so, or may (optimistically) believe that they can rely on regulators to mitigate the effects of the withdrawal of a firm.</li> </ul> <p><b>Effects of current market characteristics</b></p> <ul style="list-style-type: none"> <li>▪ Some companies might react to an audit firm incident without having considered all available information or options.</li> <li>▪ Some companies might not evaluate options for how to mitigate the possible loss of their audit firm.</li> </ul> <p><b>Characteristics of a more efficient market</b></p> <ul style="list-style-type: none"> <li>▪ Directors of public interest entities consider whether to identify the possible withdrawal of their auditor from the market as a risk to the company achieving its business objectives.</li> <li>▪ Directors of public interest entities evaluate options for mitigating risks arising from the possible withdrawal of their auditor from the market. If considered appropriate, they take selected actions to reduce the potential impact of the risk.</li> </ul> <p><b>Provisional recommendation 15</b></p> <ul style="list-style-type: none"> <li>▪ 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.</li> </ul>	<p><b>Effectiveness</b></p> <p>There was general support for raising awareness of the need to include the risk of the withdrawal of the audit firm from the market in companies' risk evaluation and planning in order to reduce uncertainty and disruption costs in the event of a firm leaving the market.</p> <p>We agree. All entities should review the significant risks that they face and develop contingency plans where necessary. <i>KPMG</i></p> <p>We agree with the objective. Companies need to decide what is appropriate for them but obviously this risk should be considered. <i>Standard Chartered</i></p> <p>It was suggested that companies should not assume that regulators' contingency measures would avoid uncertainty and disruption.</p> <p>We support this as an effective market-based approach to this issue. It is important that companies do not rely solely on regulators to mitigate the effects of the withdrawal of a firm although we take it as read that the FRC has its own contingency plans in place. <i>CIMA</i></p> <p>This is clearly an important risk that companies need to be aware of and plan for to the extent that this is possible. However this is unlikely to enable companies to gain a high level of assurance that contingency plans can be devised and be capable of being put into operation in all conceivable circumstances of failure of an audit firm. The regulatory response would be a very relevant factor and we anticipate the FRC has itself given thought to what temporary or permanent changes are required in its stance. <i>Association of British Insurers</i></p> <p>It was noted that for some companies their options for mitigating the risk may be very limited.</p> <p>We consider it impracticable for companies to maintain back up arrangements, given that the supply side for audit services offers such little choice and especially with the difficulty of finding another firm that is independent and that does not have too big an involvement with a competitor of the audit client. A radical change in the supply side of the large firm audit market would provide more realistic opportunities to establish contingency plans. It would also reduce the necessity for these because greater choice would enable a would-be client to find a new auditor more easily and quickly in case of need. <i>Rio Tinto</i></p> <p>We are not sure that there is a great deal of substance that boards can do to fulfil this proposal and therefore are not sure that it should be pursued with any vigour. <i>Hermes</i></p>

### Consultation responses

#### Effectiveness

There was general support for raising awareness of the need to include the risk of the withdrawal of the audit firm from the market in companies' risk evaluation and planning in order to reduce uncertainty and disruption costs in the event of a firm leaving the market.

We agree. All entities should review the significant risks that they face and develop contingency plans where necessary. *KPMG*

We agree with the objective. Companies need to decide what is appropriate for them but obviously this risk should be considered. *Standard Chartered*

It was suggested that companies should not assume that regulators' contingency measures would avoid uncertainty and disruption.

We support this as an effective market-based approach to this issue. It is important that companies do not rely solely on regulators to mitigate the effects of the withdrawal of a firm although we take it as read that the FRC has its own contingency plans in place. *CIMA*

This is clearly an important risk that companies need to be aware of and plan for to the extent that this is possible. However this is unlikely to enable companies to gain a high level of assurance that contingency plans can be devised and be capable of being put into operation in all conceivable circumstances of failure of an audit firm. The regulatory response would be a very relevant factor and we anticipate the FRC has itself given thought to what temporary or permanent changes are required in its stance. *Association of British Insurers*

It was noted that for some companies their options for mitigating the risk may be very limited.

We consider it impracticable for companies to maintain back up arrangements, given that the supply side for audit services offers such little choice and especially with the difficulty of finding another firm that is independent and that does not have too big an involvement with a competitor of the audit client. A radical change in the supply side of the large firm audit market would provide more realistic opportunities to establish contingency plans. It would also reduce the necessity for these because greater choice would enable a would-be client to find a new auditor more easily and quickly in case of need. *Rio Tinto*

We are not sure that there is a great deal of substance that boards can do to fulfil this proposal and therefore are not sure that it should be pursued with any vigour. *Hermes*

C: Reduced uncertainty and disruption costs in the event of a firm leaving the market

## Recommendation 15: Planning by companies for risk of their audit firm leaving the market (ii)

### Consultation responses (continued)

#### *Effectiveness (continued)*

It was noted that the need to carry out appropriate risk evaluation and planning is already understood by companies.

The need to mitigate the risk of withdrawal of their auditor from the market is already well understood by major public companies. Furthermore, we do not believe that disclosure other than in very general terms of the nature of the actions taken to mitigate this risk is appropriate. Many of these actions are likely to be commercially sensitive. *Royal Bank of Scotland*

Major public interest entities should evaluate the material risks to which they are exposed and plan accordingly. This proposal, while unobjectionable, seems to us to be unnecessary. *PricewaterhouseCoopers*

The suggestion in the interim report that directors should advise shareholder of whether they have a risk mitigation plan in place was seen as unnecessary.

There is a risk that the communication with shareholders through the audit committee report may become a boilerplate disclosure. We would recommend that such disclosure is only made where there is a reasonable risk of such a withdrawal or where there is an absence of market choice of some other factor which would merit the issue being brought to the shareholders attention. *Hundred Group*

#### **Quality & Cost**

No comments made.

### Conclusions

Market participants generally agree that part of the responsibility for reducing uncertainty and disruption costs in the event of a firm leaving the market rests with boards of companies. Very large companies might have limited options for managing the risk although some could identify a possible alternative auditor. The appropriate response to the risk will vary by company and will be a matter for boards and their audit committees to judge.

While the response of regulators to a possible or actual loss of an audit firm could be important, it is very unlikely that regulators could avoid there being uncertainty and disruption costs for companies. It is therefore important that more companies consider what actions are possible to protect their interests.

On this basis, having considered the consultation responses, the Group confirmed the provisional recommendation without amendment.

### Recommendation 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.**

## Appendix 1 – Terms of reference of Market Participants Group

### Background

1. The objectives of the 'Choice in the UK Audit Market' project are to identify, assess and promote actions to enhance the efficiency of the market for the audit of major public interest entities in the UK and mitigate the risks arising from the characteristics of the market. In undertaking this work, the FRC recognises the importance of the quality of audit work and is committed to avoiding actions that would damage the quality of audit services.
2. The intended outcomes from this project include:
  - Increased choice of auditors.
  - Reduced risk of an audit firm leaving the market without good reason.
  - Reduced uncertainty and disruption costs in the event of an audit firm leaving the market.
3. The nature of the risks associated with the current characteristics of the market for the audit of major public interest entities are such that actions may be required by each of:
  - Market participants
  - Regulatory authorities
  - Legislators.
4. In the first stage of the project the FRC has:
  - Jointly with the Department of Trade and Industry commissioned a study, "Competition and Choice in the UK audit market".
  - Published a Discussion Paper for consultation in May 2006.
  - Facilitated a public debate by hosting two stakeholder meetings and publishing responses to the Discussion Paper.

### 5. In the second stage of the project, the FRC will:

- Convene a Market Participants Group that will identify and assess possible market-led actions to mitigate risks.
- Liaise with other relevant regulators to identify and assess possible regulatory actions to mitigate risks.
- Consult widely over actions proposed for implementation.
- Agree with market participants and other regulators specific steps to implement actions to mitigate risks.

### Purpose and activities of the Market Participants Group

6. The Market Participants Group has been established to provide advice to the FRC and, in particular, it will identify and assess possible actions which market participants could take to mitigate the risks arising from the characteristics of the market for the audit of major public interest entities in the UK.
7. The primary focus of the Group will be actions that would be carried out by market participants. The FRC will, separately, work with other regulators to identify and assess actions that could be carried out by regulators. There will be regular communication between the Market Participants Group and the Regulators Group.

8. The Group will build on responses to the FRC's Discussion Paper and the debate at the second stakeholder meeting. The activities of the Group are expected to include:
  - Defining the risks arising from the characteristics of the market.
  - Defining the criteria by which possible actions to mitigate risks should be assessed.
  - High-level assessment of a 'long list' of possible actions.
  - Further assessment of a selection of possible actions to mitigate risks.
  - Reporting on the outcome of the assessments.

### Composition and membership

9. The Market Participants Group will comprise of individuals from stakeholder groups in the market for the supply of, and demand for, audit services to major public interest entities in the UK. The three principal stakeholder groups are:

- The entities being audited
- The firms providing audit services
- Shareholders and other users of audit services

10. The membership should provide, to the extent practicable, a balance of participation across the different stakeholder groups. The composition of the Group has been approved by the FRC Council.

11. Members of the Markets Participants Group will be appointed as individuals based on their knowledge about the preparation or use of audit reports, and the auditor selection process and their seniority. They will not be expected to represent their own organisations but instead to have regard to the public interest.

### Operating procedures

12. The Chief Executive of the FRC will be the Convenor of the Group. The Convenor will chair meetings, ensure that members are able to have a full say on the issues being raised and discussed and encourage members to reach collective views on issues and how best to address them.
13. The Secretariat of the Group will be provided by the FRC. The Secretariat will prepare draft project plans, agendas and minutes of meetings for consideration by the Group and will ensure effective liaison between the Market Participants Group and the work of the FRC and other regulators on regulatory measures. The FRC will carry out technical analysis on behalf of the Group.
14. The Group is expected to meet around once a month for 2 to 3 hours. Members may also be asked to comment on papers outside of the meetings.
15. The Group will be expected to operate in a transparent manner, with information on its activities being made publicly available. The Group will report publicly on its views once these have been agreed.

## **Appendix 2 - The Market Participants Group**

The Market Participants Group was comprised of individuals from stakeholder groups in the market for the supply of, and demand for, audit services to major public interest entities in the UK. The three principal stakeholder groups are:

- The entities being audited
- The firms providing audit services
- Shareholders and other users of audit services

### **Members of the Group:**

- Philip Broadley, Group Finance Director, Prudential plc and Chairman of the Hundred Group of Finance Directors
- Michael Cleary, National Managing Partner, Grant Thornton UK LLP
- John Connolly, Senior Partner and Chief Executive, Deloitte UK, Deloitte & Touche LLP
- David Herbinet, Partner & Head of Public Interest Markets, Mazars LLP
- Huw Jones, M & G Investment Management Limited
- Professor Ian Percy CBE, Deputy Chairman of the Weir Group plc and Ricardo plc
- Michael Power, J P Morgan Cazenove
- David Robertson, Finance Director, Mears Group plc
- Derek Scott, Chairman, Stagecoach Group Pension Scheme trustees
- Robert Talbut, Chief Investment Officer, Royal London Asset Management
- Brian Walsh, former Deputy Chairman and Chairman of Audit Committee, Nationwide Building Society
- Peter Wyman CBE, Partner, PricewaterhouseCoopers LLP

Group Convenor: Paul Boyle, Chief Executive, Financial Reporting Council

### Appendix 3 – Respondents to Interim Report

The Market Participants Group is grateful to all those who commented on its Interim Report:

Aggreko plc  
 Mr Duncan Alexander  
 Amlin plc  
 Associated British Foods plc  
 Association of British Insurers  
 The Association of Chartered Certified Accountants (ACCA)  
 Association of Corporate Treasurers  
 Baker Tilly UK Audit LLP  
 Mr Antony Beevor  
 BDO Stoy Hayward LLP  
 British Bankers' Association  
 Professor Ewan Brown  
 Mr Peter Bunting  
 CBI  
 The Chartered Institute of Management Accountants (CIMA)  
 Deloitte & Touche LLP  
 Mrs Margaret Downes  
 Ernst & Young LLP  
 European Group of International Audit Networks  
 Governance for Owners LLP  
 Grant Thornton UK LLP  
 Herbert Smith LLP  
 Hermes Investment Management Limited  
 The Hundred Group of Finance Directors  
 Independent Audit Limited

The Institute of Internal Auditors - UK and Ireland  
 The Institute of Chartered Accountants in England and Wales (ICAEW)  
 The Institute of Chartered Accountants of Scotland (ICAS)  
 International Corporate Governance Network  
 Investment Management Association  
 KPMG LLP  
 Mazars LLP  
 Mr Kevin McMeeking  
 Mr Patrick Mordacq and Mr Jean-Louis Mullenbach  
 National Association of Pension Funds  
 National Grid  
 PricewaterhouseCoopers LLP  
 The Quoted Companies Alliance  
 Rio Tinto plc  
 Royal Bank of Scotland Group plc  
 Mr Peter Smith  
 St Modwen Properties plc  
 Standard Chartered plc  
 Standard Life Investments Limited  
 Mr Nicolas Véron

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Further information about the Audit Choice project may be found at

<http://www.frc.org.uk/about/auditchoice.cfm>



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