HOUSE OF LORDS

Auditors: Market concentration and their role

Written Evidence

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Memorandum by Grant Thornton UK LLP

1.1 We welcome the opportunity to respond to the call for evidence.

1.2 Grant Thornton UK LLP is a leading financial and business adviser operating from 28 offices. Led by 215 partners and employing nearly 4,000 of the profession's brightest minds, we provide personalised assurance, tax and specialist advisory services to over 40,000 individuals, privately-held businesses and public interest entities.

1.3 Specifically in respect of public interest entities:

- we audit 271 companies listed in the UK of which 186 are on AIM and 85 on main market[1]
- we work with one in six of the FTSE 100 in providing non-audit services
- we audit 25 local authorities as a chosen supplier to the Audit Commission including Manchester City Council and three London Borough Councils
- we are also a leading assurance provider to the National Audit Office
- we publish the FTSE 350 Corporate Governance Survey.

1.4 We are a member firm of Grant Thornton International Ltd, one of the world's leading international organisations of independently owned and managed accounting and consulting firms. Clients of member firms can access the knowledge and experience of more than 2,500 partners and 30,000 professional staff in over 100 countries and consistently receive a distinctive, high-quality and personalised service, wherever they choose to do business.

1.5 Given our capabilities in the public interest sphere, we believe we are well placed to provide the Select Committee with our perspective on market concentration and the role of the auditor.

1.6 We believe the questions posed by the Committee fall into two broad categories i) market concentration and ii) lessons from the financial crisis on the role of the auditor and we summarise our main comments on these two areas below:

2 Market concentration

2.1 We are not aware of any evidence that the presence of four large firms has led to excessive fees being charged or had an adverse effect on audit quality in the markets that we serve. The current audit market structure is not viable in the long term, because the failure of another large firm would leave the market with too few firms and could lead to the exit of other firms. Market confidence would be significantly dented and the resulting market structure could create the further moral hazard that the remaining firms are perceived to be "too big to fail". This would reduce price competition and lessen the pressure to maintain audit quality.

[1] Source: The Hemscott Rankings Guide May 2010

2.2 If this is accepted as a premise, in view of the international structures within which we and the other large audit firms operate, and absent global regulatory intervention, the only viable solution is forcibly to drive greater competition and choice as a medium term contingency plan. If one of the largest firms failed under the current market structure, an orderly transition would be difficult to effect and it is unlikely that people with requisite skills would choose to move to the next largest firms such as Grant Thornton and BDO, for example, because of differentials in partner remuneration.

2.3 The soft touch initiatives promoted by the FRC have demonstrably not worked. While there is no "silver bullet", we believe that regulatory intervention could achieve meaningful changes in the structure of the audit market to widen and deepen participation beyond just four firms over, say, a five year period.

2.4 For this reason, we are calling for the following:

- a regulatory code of conduct or an unequivocal statement from investors promoting the wider use of firms outside the four largest; in the first instance this might be as auditors of subsidiaries within large, public listed groups

- placing tapered limits on the market share of firms measured by the number of appointments held over, say, a five year period, monitored by representatives from regulators and investors

- prohibition of contractual restrictions that prevent companies from appointing firms other than the four largest for audit and/or related services.

2.5 There are helpful lessons which could be learned from the UK public sector audit market, where there is less institutional prejudice, audit quality is high and where there is a widespread view that audited entities receive value for money. In this market, independent appointments bodies monitor audit appointments, audit quality, value for money and tenders.

2.6 The ultimate aim should be, within the medium term, to create a vibrant, competitive but sustainable market for large listed company audits since healthy competition is a long term driver of both innovation and quality. Both capital markets and audit quality would benefit in the long term were a more level playing field to exist between firms which are part of global networks.

2.7 There is widespread concern that four dominant firms are too few, and in particular that the market is unduly exposed to systemic risk from the collapse of another large firm. This has led to studies on audit market concentration in a number of jurisdictions, including the UK, the EU and the US. We understand that in Japan following the withdrawal of the auditing licence from one of four largest audit firms, the regulators were forced to step in and oversee the creation of a new audit firm and effect a transfer of audits. This demonstrates that this is a tangible rather than purely an academic risk.

2.8 Grant Thornton has a successful and well regarded business model and is now widely seen as the leading firm in the privately-held business and small listed company sectors. We are part of Grant Thornton International, a global organisation, which is

responding to the market demand for more choice and has encouraged significant investment in its member firms. In terms of audit services, the global breadth and depth of our resources now means that Grant Thornton International member firms have the capability today to audit most large listed companies around the world. What holds us back is a misguided belief that big is better. The pervasive use of the term Big 4 inadvertently perpetuates the belief that there are only four global audit players with the capability to audit large listed companies. Despite the increasing evidence from independent audit inspections, the term Big 4 continues to be used as a short-cut for quality and it is this IBM effect (the perception of there being no recognisable upside to appointing a non-Big 4 firm but considerable perceived downside risk for individuals who make appointments) which remains the biggest barrier to entry for us in this market.

3 The role of the auditor

3.1 We are proud of the role that audit plays in underpinning capital markets by providing investors and potential investors with confidence in the reported performance of quoted companies. We do, however, recognise the risk of the perception gap; the difference between what investors may believe an audit delivers compared with what is actually delivered. We would suspect that any perceived shortcomings in auditing in relation to the financial crisis are more likely to have arisen as a result of the current limitations on what constitutes an audit as opposed to failures to perform those tasks that presently are required as part of an audit.

3.2 The Policy and Regulatory Group ("PRG") which represents the six largest UK firms on public policy issues, and which we chair, has made the following recommendations to the FRC:

- a publication to be prepared by the ICAEW to raise awareness of what a modern audit entails and how auditors discharge their duties to ensure audited financial statements give a true and fair view

- the establishment by the FRC of a working group, including preparers, investors, auditors and BIS, to develop a framework which would enable large listed companies to provide enhanced and more relevant disclosures in areas such as the business model, risks, and management estimates and judgments; in due course these enhanced disclosures might encompass controls reporting and sustainability

- the establishment of a further group to develop a framework for the provision of assurance reports on these enhanced disclosures.

We have also urged the FRC and BIS to consider safe harbour provisions for preparers and auditors who publish enhanced disclosures and assurance statements diligently.

3.3 As a member of the ICAEW Financial Services Faculty, we support the Faculty's June 2010 Report on an enhanced role for the auditors of banks. Among the key policy proposals it contains are:

- more frequent bilateral and trilateral meetings between the prudential supervisor and audit firms on both generic pressure points within the sector and bank specific matters

- specific, targeted reports to the supervisor by bank auditors, or another audit firm, on regulatory returns, control activities and governance

- views on how to establish a coherent framework which would enable banks to provide high quality disclosures on matters such as more detailed explanation of the business model and identification of key risks, a detailed going concern statement, a capital statement and benchmarking. These disclosures would be reported on by an auditor.

3.4 Should, as has been proposed, a further working group be established to develop a framework for provision of assurance reports on the enhanced disclosures, then this could be designed in such a way to permit the involvement of a firm other than the statutory auditor to opine on these disclosures. We see no reason why the provision of this opinion need be restricted to the largest four firms and could see this as a possible method for delivering the benefits of multiple auditors to stakeholders, companies and audit firms seeking a foothold in the large listed market.

3.5 On the following pages we provide brief answers to the questions raised by the Committee. In the interests of brevity, we have grouped some questions together and provided one response which addresses all the questions in that group.

3.6 We commend the Committee for its interest in these vital areas of auditor concentration and the role of the auditor.

24 September 2010

4 APPENDIX: Responses to individual questions

Question 1: Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

4.1 At the end of the 1980s, following a period of radical change and significant growth in the profession as well as a series of mergers and acquisitions, the market started to refer, for the first time, to a Big 8. Grant Thornton made a decision to focus on owner-managed businesses, as that segment of the market where we could legitimately claim to be the leader. Following the advent of the Big 8 firms by the late 1980s, subsequent mergers within this group resulted in a Big 6 by 1989 and it was the combination of Price Waterhouse with Coopers and Lybrand in 1998 followed by the demise of Arthur Andersen in 2001 that saw six become four.

4.2 Grant Thornton has the global breadth and depth of resources to audit all but the very largest of the listed companies around the world. We believe that it is a common misconception that there are only four global audit players with the capability to audit large companies. In the large listed market, the biggest barrier to entry we face is not economies of scale but the relative strength of the brand names of the Big 4. This culminates in the IBM effect whereby few audit committees want to risk appointing a firm without such an established strong brand for fear of personal criticism for being out of step with market thinking. The point at which economies of scale would prove a bar to our competing is very

high, perhaps the upper reaches of the FTSE 100. If there were genuine opportunities to grow our presence in the large listed market, we would invest further in this market.

4.3 The significant differentials in partner incomes between the four largest firms and the next largest firms is a likely barrier to the partners from a collapsed firm joining such a firm, instead they would seek to join one of the three remaining largest firms leading to an audit market concentrated on just three large firms. This would create a further moral hazard to the detriment of capital markets since these three firms might be considered de facto to be too big to fail. To date, the soft-touch initiatives promoted by the FRC have demonstrably not worked, hence we are calling for direct intervention forcibly to drive greater competition and choice in the large listed audit market which we are confident would at least maintain audit quality.

4.4 We submit that in order to protect capital markets from the inevitable chaos that would descend were four to become three, policy makers and regulators should give serious consideration to the case for regulatory intervention. The firm's current medium term strategy is to provide large corporates with advisory services in sectors where we can demonstrate credibility with a view to showcasing the global capabilities of our organisation such that we will in the future be invited as genuine contenders to tender for the provision of audit services.

4.5 We encourage investors and policy makers to consider other markets where audit quality is high but concentration low, such as the public sector audit market in the UK. Notably this market exhibits the following features; periodic audit tenders, independent bodies which monitor quality and determine appointments and fees, and a broader audit scope to encourage bold assurance and value for money statements.

4.6 Consultation should be sought as to whether there is support among investors for an independent body monitoring appointments and fees and/or the introduction of tapered, over a five year period say, restrictions on the market share of audit firms in order to reduce concentration in the large, public listed audit market and lessen the impact of any collapse of one of the largest audit firms. This should be supported by initiatives to encourage large, listed companies to explore the benefits of using firms other than the four largest to provide non-audit services and using multiple audit firms to carry out the audit work on groups, for example, using an alternative audit firm to audit components of the group. At the same time, intermediaries such as banks should be prohibited or discouraged from including contractual restrictions that limit audit or related appointments to the four largest firms.

Question 2: Does a lack of competition mean clients are charged excessive fees?

Question 3: Does a narrow field of competition affect audit objectivity of advice provided?

Question 4: Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

Question 9: If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

4.7 We are not aware of any evidence that audit fees are excessive in the markets in which we operate. Audit fees are negligible in comparison with the market capital values of the audited companies. Nor do we consider that greater concentration has reduced audit objectivity or quality. All firms would recognise that reputational risk is so great that, like an airline, we simply cannot afford any crashes. For this reason, whatever the field of competition, no firm can afford to be anything less than fully robust in terms of the objectivity of the advice provided. This desire of audit firms to safeguard their own reputations is augmented by a strong, independent inspection process, the results of which are now published. We consider that these are adequate safeguards of audit quality and strong incentives to provide objective advice to clients even where it may be unwelcome. We and other firms have in place procedures to prohibit the acceptance of audits where we suspect that management are so-called "opinion shopping" or seeking to find alternative advisors who will sign up to a proposed accounting treatment that their current advisors have refused to endorse. We think that the FRC already has the tools it requires to ensure that we and the other large audit firms maintain a healthy degree of scepticism when conducting their work and that this remains the most effective regulatory approach.

Question 5: What is the role of auditors and should it be changed?

4.8 We do recognise that there is a compelling case for the role of the auditor to be enhanced for some or all listed companies as well as banks. We are actively promoting debate with investors and other stakeholders on this and other topics.

4.9 The Policy and Regulatory Group ("PRG") which represents the six largest UK firms on public policy issues, and which we chair, has made the following recommendations to the FRC:

- a publication to be prepared by the ICAEW to raise awareness of what a modern audit entails and how auditors discharge their duties to ensure audited financial statements give a true and fair view

- the establishment by the FRC of a working group, including preparers, investors, auditors and BIS, to develop a framework which would enable large listed companies to provide improved and more relevant disclosures in areas such as the business model, risks, and management estimates and judgments; in due course these enhanced disclosures might encompass controls reporting and sustainability

• the establishment of a further group to develop a framework for the provision of assurance reports on these enhanced disclosures.

We have also urged the FRC and BIS to consider safe harbour provisions for preparers and auditors who publish enhanced disclosures and assurance statements diligently.

4.10 As a member of the ICAEW Financial Services Faculty, we support the Faculty's June 2010 Report on an enhanced role for the auditors of banks. Among the key policy proposals it contains are:

• more frequent bilateral and trilateral meetings between the prudential supervisor and audit firms on both generic pressure points within the sector and bank specific matters

• specific, targeted reports to the supervisor by bank auditors, or another audit firm, on regulatory returns, control activities and governance

• views on how to establish a coherent framework which would enable banks to provide high quality disclosures on matters such as more detailed explanation of the business model and identification of key risks, a detailed going concern statement, a capital statement and benchmarking. These disclosures would be reported on by an auditor.

4.11 These recommendations would further enhance users' understanding of the entity's results and state of health.

4.12 Should, as has been proposed, a further working group be established to develop a framework for provision of assurance reports on the enhanced disclosures, then this could be designed in such a way to permit the involvement of a firm other than the auditors to opine on this report. We see no reason why the provision of this opinion need be restricted to the largest four firms and could see this as a possible method for delivering the benefits of multiple auditors to stakeholders, companies and audit firms seeking a foothold in the large listed market.

4.13 At the same time, we would caution that the existing arrangements remain appropriate for the vast majority of our smaller listed companies. Therefore any expansion of the audit scope beyond banks and the large, sophisticated listed companies may need to be weighed carefully to ensure that it is proportionate for those smaller, less complex businesses and does not unduly increase the compliance burden for them without providing any additional assurance to stakeholders.

Question 6: Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

Question 7: What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of the banks?

Question 8: How much information should bank auditors share with the supervisory authorities and vice versa?

4.14 We believe that there should be free and open, two-way communication between the prudential supervisor and bank auditors. We accept that this will require the audit firms, as well as the supervisor, to educate their people to ensure that this dialogue is both full and frank such that it is a meaningful and productive as possible and we are committed to doing this.

4.15 We are aware that the FSA and FRC have raised questions around professional scepticism by audit firms and we are participating in that debate. At present we do not believe that firm conclusions have been reached, and we would simply reiterate our belief that healthy competition is a long term driver of innovation and quality. We note that the FSA has reported that even where it disagrees with judgments made by preparers, and accepted by auditors, it has found no cases where it believes the 2007 (pre-financial crisis) financial statements prepared by banks and large financial institutions failed to give a true and fair view. In our responses to the FSA, we have made the point that the FSA should make greater use, than was the case around 2007, of skilled persons ("Section 166") reports on selected governance and other issues at regulated financial services companies and that in many of those cases it would be more appropriate for a firm other than the auditor to carry out those reports. This is one way in which greater competition might be promoted.

4.16 Grant Thornton was the first firm to call for publication of the results of independent audit inspections. If there is evidence of examples of inadequate professional scepticism we believe the FRC should be robust in dealing with them, including reporting the firm publicly where necessary. If such a case were felt to involve a Grant Thornton audit, we commit to dealing with the matter and any training needs robustly. If there are examples at other firms we do not believe we should be tarred with a broad regulatory brush.

4.17 We have raised a concern that the FSA, the current prudential supervisor in the UK, operates within certain legal constraints that it believes limit the amount of information it may share with the auditors of a bank or other financial institution. If so, we believe it would be timely for such legal constraints to be re-examined.

Question 10: Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

4.18 Indisputably conflicts of interest can arise between audit and consultancy roles. In our experience the existing principles already result in the decline of appointments that would result in a genuine conflict of interest. Those that remain are largely a matter of perception, and this view has been echoed by a number of large UK institutional investors we have spoken with. We would not support any further prohibitions on non-audit

services provided by auditors since we believe that this would likely result in additional costs to companies for little or no benefit.

4.19 We do, however, support robust mechanisms to preserve both the appearance and actuality of auditor independence and specifically the IFAC Code of Ethics which is accepted by a large number of countries around the World. In the UK, the Ethics Standards which govern the ability of audit firms to provide non-audit services to their audit clients and the Smith Guidance which governs the way audit committees of listed companies oversee provision of other services by their auditor are monitored by the AIU. We are satisfied that the current guidelines are sufficient for these purposes provided all firms honour the principles of the standards and do not seek to treat them as rules which can be bent to permit undertaking assignments that may in fact be contrary to the principles of the standards. We support the recommendations of The Institute of Chartered Accountants of Scotland that audit committees of listed companies should provide clearer information about their policies to avoid conflicts of interest arising and reasons for involvement of auditors in providing substantial non-audit services.

Question 11: Should more competition be introduced into auditing? If so, how?

4.20 We believe that it is of paramount importance that more competition and choice be introduced into the large, listed audit market in order to mitigate the catastrophic damage that could be caused by the collapse of four into three large firms. We are calling on policy makers and regulators to consider regulatory intervention. We suggest examination of other markets (such as the public sector market in the UK) where audit quality is high and concentration is low and consideration of the following:

- a regulatory code of conduct or an unequivocal statement from investors promoting the wider use of firms outside the four largest; in the first instance this might be as auditors of subsidiaries within large, public listed groups

- placing tapered limits on the market share of firms measured by the number of appointments held over, say, a five year period, monitored by representatives from regulators and investors

- prohibition of contractual restrictions that prevent companies from appointing firms other than the four largest for audit and/or related services.

Question 12: Should the role of internal auditors be enhanced and how should they react with the external auditors?

Question 13: Should the role of audit committees be enhanced?

Question 14: Is the auditing profession well placed to promote improvement in corporate governance?

4.21 Internal audit is an important aspect of a company's governance and risk management. It is the responsibility of management to put in place a system of internal control appropriate to the size and complexity of the business and internal audit plays an important role by enabling management to monitor both the design and operation of internal controls. We believe it is essential that there is no blurring of the lines between

internal and external audit but instead a full and open dialogue between internal and external auditors.

4.22 We believe that audit committees have a key role in bringing about the enhanced disclosures we have suggested in our covering letter. We are proposing that listed company financial statements should include an audit committee report which provides clear disclosures on the business model, risks and critical management judgments and estimates and that the auditor or another audit firm provides a fairness opinion on that report. A framework for the provision of this additional assurance will need to be agreed so that the responsibilities of management and the auditor are clearly defined and understood by all parties.

4.23 The auditing profession is well placed to promote improvements in corporate governance. Providing assurance over governance statements and advising on this subject are at the heart of the skill set of large audit firms. It is already a part of the audit of a listed company, since the auditor is required to report on parts of the Governance Code. Many of the large audit firms have substantial specialist teams that deal with governance advice. For example, Grant Thornton has produced the FTSE 350 Corporate Governance Survey which sets out a seven year trend of compliance with the Governance Code by the UK largest listed companies and our specialists were consulted last year by Sir David Walker and the FRC in their respective reports on governance reform.

Memorandum by Mr Michael A. Hadfield

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1 The Auditing became so concentrated on four global firms because the Institute of Chartered Accountants in England and Wales (ICAEW) allowed and encouraged them to do so.

The ICAEW withdrew all controls over the large firms as it was and remains a case of he who calls the piper calls the tune.

2. It is obvious to all that the lack of competition has resulted in excessive fees. This has resulted in the firms being complicit when errors are found and they have given clean and unqualified Audit Reports upon which the members and Creditors have relied in order to retain the Audit Fee.

3. The ICAEW were aware of this but have taken no action against them. However in order to try and influence Government that they are effective prosecute small firms for minor errors that make no difference to the accounts in an effort to show they are “doing the job”.

4. The role of Auditors should be restricted to just that. Other advice should be sought from other firms (possibly in conjunction with the Auditors).

5. The Auditors should not give clean reports unless they are able to say that they fully understood the Banks transactions. If they claim that they did then they were acting in a

criminal manner if they did not then they should have resigned. In either case they did nothing nor did the ICAEW who, it would appear, is capable of taking action against them.

6. Of course they were not sufficiently sceptical because the juniors sent out on Audit did not understand what was happening.

7. They should have acted honestly and qualified the accounts.

8. All matters should be shared with the body to which they belong i.e. in the main the ICAEW but as already indicated they had already, in self interest, abdicated their responsibility.

9. There should be no need for an honest broker to receive incentives. The only incentive should be exactly the same as small firms which is either having their Audit Registration removed and /or being struck off. All firms irrespective of size should be on the same level playing field.

10 to 11 No comments.

23 September 2010

Memorandum by The Hundred Group

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1. We are pleased to submit our comments on the above call for evidence.

Who we are

2. The Hundred Group is a non-political, not-for-profit organisation which represents the finance directors of the UK's largest companies, with membership drawn mainly, but not entirely, from the constituents of the FTSE100 Index. Our aim is to contribute positively to the development of UK and International policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the view of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

Our views

3. We welcome the House of Lord's consultation and the opportunity to respond on these issues.

4. Due to the nature of the consultation we have not sought to answer the questions raised by the Committee. As preparers of financial statements we recognise that the ownership of the audit relationship must be between shareholders and auditors. We do not seek to comment on the requirements of shareholders, nor would it be appropriate for us to guide

the regulatory requirements in this arena. However, we express in this letter our thoughts as management in so much as they may be relevant to the Committee's deliberations.

5. In overview, we are supportive of the current role of the auditors and the value brought to our shareholders through the audit report and through other services rendered to our members. We note the common practice of investors to utilise the audited financial statements as a reference point throughout the financial cycle, the value of which is enhanced by the associated audit report.

6. We are of the opinion that the services rendered by the 'Big 4' are of a high quality and that there exists sufficient competition in the market place to drive continuous improvement and breadth of choice to our shareholders. In particular we note the high level of competition demonstrated during an audit tender process. In our experience this process brings out a high degree of competition in terms of emphasis of approach and on audit fees paid.

7. We appreciate and recognise the value that we, as management, benefit from the ability to use our auditors to undertake non audit services where appropriate. We strongly believe that we must retain the ability to select service providers based on the highest standard of deliverable, including circumstances where the service provider is our auditor. We make this statement whilst recognising the importance of independence between management and auditors and the need to ensure at all times that this is not breached through appropriate safeguards.

8. We do not feel that the Audit market is unduly concentrated. Indeed, we see that in some arenas there is a 'Big 6' of accountancy firms providing increased competition. For our members, however, the importance of 'global reach' in an audit firm is imperative. The majority of our member organisations are global in reach and, with trade barriers opening up and market growth projections persistently dominated by developing markets we see huge growth possibilities outside the European Union.

9. Our service providers, including our auditors, are expected to be able to rise to the challenge of auditing our complex, global businesses. The barriers to entry for a global audit firm are high and require a certain 'critical mass' to be effective. Current requirements under *ISA600: Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors* require significant input from group auditors which is practically translated as a requirement for group auditors to audit the majority of a group's global subsidiaries. This in turn will preclude smaller firms from competing in the global arena. Therefore our membership will almost exclusively seek an audit from one of the 'Big 4' auditors. The establishment of global networks necessarily takes time and the assembly of a critical mass which we feel would be inappropriate to force.

10. In addition larger auditing firms will, by their nature, have a broader base of experience to draw from when conducting their audits. Our membership represents companies that are fully listed, are acquisitive, raise debt, purchase intellectual property, have complex tax structures and run international treasury functions. These activities require advisors who have a broad background of experience to service us appropriately. In our experience the Big 4 are consistently and comfortably able to deliver the expertise we demand of our auditors and accordingly our members and their shareholders predominantly look to the Big 4 when considering new auditors.

11. We understand the basis for questioning the role of the auditor and the reporting requirements of the auditors to external bodies where appropriate. However, we would caution against any developments which will, either directly or indirectly, affect the relationship between the auditors and the audit committee. The frank, open and challenging relationship which is demonstrated in our audit committees is one which both management and non-executives value and is, in our view, effective at challenging management and the audit committee appropriately.

27 September 2010

Memorandum by Independent Audit Limited

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1. Thank you for your invitation to give evidence to the Enquiry of the Select Committee on Economic Affairs into the above topic.

2. Independent Audit Limited provides clients with independent assurance and advice on matters relating to corporate governance, risk management and compliance assurance, ranging from board and audit committee effectiveness to the effectiveness and value for money of their external audits. We have expertise in financial statement auditing but do not undertake such audits ourselves.

3. Concentration of the audit market on the Big Four firms is most apparent in certain sectors, particularly listed companies and financial services organisations. The audit market for private companies, especially smaller ones, is very different, with much more competition, and is not addressed by this paper.

4. There has been no systematic evidence of audit failure relating to the recent financial crisis and in our view it is mistaken to seek to blame individual auditors for not having helped to prevent it. It is true that they did not seem to see it coming, but sadly they were not alone in this. Very few people saw the crash coming, and even those who did could not predict its timing. Auditors fell into the same trap as most of the rest of us, including those charged with economic policy and regulation of the financial services industry. And while it is true that audited accounts failed to draw attention to the stresses building up in the financial system, this is a failing not of individual audits but of the system within which audits are performed.

5. Criticism of auditors for their role in the financial crisis, or rather their absence of role in preventing it, seems largely to arise from a difference in expectations between those of the critics and those of the profession. Some of the critics seem to look to auditors to protect society from the ravages of capitalism, and their views, although usually expressed with eloquence and vigour, are perhaps better considered in a forum other than the present one.

6. A more significant, albeit sometimes less dramatically communicated, body of criticism originates from people who do not wish to change the nature of economic society

but whose expectations are that audit will increase their understanding of management effectiveness, financial strength and business model resilience. The audit profession generally fails to meet these expectations and it is not immediately obvious to those outside the profession that this is because the expectations are fundamentally unreasonable. Once again, however, this is not the fault of individual auditors but of the system within which they have to operate.

7. The system of audit is characterised by a number of very distinctive features, which are to a large extent interdependent. These include:

7.1. "Clean" audit opinions have very low information value. Most of the words in them are standard boilerplate and are devoted to explaining what the auditor has not done and cannot be held responsible for.

7.2. The words in a clean audit opinion are usually identical regardless of the degree of risk in the financial statements and the extent of rigour in the audit. They contain nothing to identify a good audit that has licked poor accounts into shape so that they have come to deserve a clean opinion. A qualified audit opinion has higher information value than a clean opinion but is not evidence of a more rigorous audit.

7.3. The most significant piece of information in a clean audit opinion is the name of the audit firm. In the absence of any other information about audit quality, readers trust well-known brands.

7.4. Many investors show little interest in the technical relevance of the audit, instead acting as if much the most useful thing to them is their ability to sue the audit firm for very large or even unlimited amounts in the event of the company's accounts proving to have been misstated. This, together with a presumption of quality, leads them to favour the big brands.

7.5. The same predisposition can be seen in lenders, whose practice, if not their official policies, is often to require borrowers to appoint one of a short list of large audit firms. The evidence for this is largely anecdotal but there seems little reason to doubt that it occurs.

7.6. The widespread perception that investors and lenders favour the large audit firms discourages audit committees from appointing smaller firms. For an individual audit committee there is little to be gained by taking the risk of departing from the safe option.

7.7. In the same way, the widespread perception that the Financial Services Authority has a preference for large audit firms means that financial services organisations have a marked tendency to play safe. While the FSA has no official policy of favouring the large audit firms, it does little or nothing to dispel the widespread perception to the contrary, nor to encourage greater competition in this sector of the market.

7.8. Auditing standards impose a largely similar process on all audits. While the firms make brave marketing efforts to differentiate their audit services, underneath the decorative trimmings each must employ much the same approach as required by the various professional and regulatory bodies who govern their practices.

7.9. The economic model of the profession is that a small number of partners profit from work carried out by a much larger number of employees. A high proportion of an audit firm's staff are trainee or recently qualified accountants. They have knowledge of accounting standards and audit process but little experience of business and even less of management. Rules aimed at increasing the public's perception of auditor independence have had the side-effect of restricting auditors' wider experience.

7.10. Auditing standards reflect this state of affairs and are translated by the audit firms into methodologies which can be completed by inexperienced staff under the supervision of a smaller number of experienced auditors. The process required by auditing standards is one which places a very high premium on the completion of satisfactory documentation as evidence that an audit has been completed and this is reflected in the firms' and the regulators' approaches to quality assurance.

7.11. Documentation tends to become an end in itself (an assertion supported by academic as well as much anecdotal evidence) and is not necessarily well correlated with what constitutes an effective audit.

7.12. The purpose of a financial statements audit is defined by law and regulation in very circumscribed terms, being to give an opinion on whether the financial statements give a true and fair view and comply with accounting standards. Much of the public expectation of audit lies beyond this tightly defined and largely historical purpose, and is therefore doomed to disappointment unless auditors choose to go beyond their remit. From the individual auditor's point of view there are few good reasons to so do, and many very good reasons not to. Liability is the most obvious one, but it is also the case that while audit firms are very well equipped to examine compliance they are much less well equipped to form a view on the subjective and sensitive topics that lie outside the financial statements remit. This is especially the case where the opinions have to do with uncertain future events of which a global liquidity crisis is the most extreme recent example.

7.13. Financial statements are essentially backward-looking and contain only limited information about other matters for which there is public demand. Information about the risks inherent in a business model, for example, is largely forward-looking, and to the extent that it is to be found in an annual report it will be in the narrative section which is not subject to audit.

7.14. Accounting standards have become much more complex and prescriptive. Although enthusiasts and the uninformed pronounce that IFRS is principles-based rather than rules-based, this assertion defies common sense. No statement of principles should be measured in thousands of pages.

7.15. IFRS can introduce a high degree of subjectivity into financial statements through accounting procedures that sometimes require a great deal of estimation, so audit judgement is required in relation to detailed calculations. However, the self-referential declaration that a true and fair view is achieved through compliance with these standards serves to reduce professional judgement in relation to the overall picture. Whether the accounts are "right" is reduced to compliance with the rules.

7.16. Regulators and lawyers generally attach considerable importance to documentary evidence of compliance with standards. Audit firms seek defence in documentary evidence

of completion of audit steps or by reference to accounting standards which relieve them of responsibility for outcomes. Not unreasonably, there is a very strong defensive motivation to avoid taking positions which can be only unreliably defended by reference to subjective notions such as "right and wrong", "true and fair" or "professional judgement".

7.17. An increasing proportion of time spent by auditors is spent on checking compliance with the increasingly voluminous accounting standards and documenting the audit process. This contributes to the cost of audit without necessarily providing a great deal of real value.

7.18. Knowledge of how these complex standards are elsewhere applied is a commercial asset to audit firms, and one which increases in value with scale. Larger firms have much more valuable knowledge of practice, as well as the capacity to commit more resources to specialist technical roles. Any new entrant to the audit market would need to invest very considerable amounts in acquiring this knowledge and developing technical expertise.

7.19. The increasing burden of regulation on audit firms and the commercial benefit of scale in accounting expertise together create a strong rationale for yet further consolidation in the audit sector, while discouraging fragmentation and increased competition. The reason consolidation is rarely seen in practice is that, as private partnerships, audit firms are usually reluctant to give up their independence.

7.20. It is sometimes argued that increased competition could be introduced through forced fragmentation – breaking up the large firms. This would be immensely difficult to do within the existing system (for example, how do you break up a large UK firm into pieces that can function effectively without also breaking up its international network, which is not within the UK's power?). And given that all the other pressures within the system are for scale and consolidation, it is not self-evident that forced fragmentation would have a net beneficial outcome.

7.21. Audit firms compete very vigorously when audits are put out for tender. However, for what are usually good reasons this happens only rarely. A change of auditors might bring a fresh point of view but it also brings ignorance, and there is some evidence that the temporary disadvantage of the latter outweighs the equally temporary advantage of the former. In years when there is no tender, the fact that there is limited market competition is largely irrelevant since price is set by negotiation, usually using the previous year's fee as a reference point.

7.22. When an audit is put out for tender, the audit firms will compete vigorously on price and on quality of service to management, but not in practice on the quality of audit. Because of the role of auditing standards and regulation, their differentiation over the quality of the audit service is restricted to peripheral matters and "froth" which clients usually disregard.

7.23. Some aspects of service to management are disguised as contributors to audit quality. The most significant of these is the large, well-integrated international network. This is something that multinational clients appreciate, since it simplifies the management of the audit process and gives access to useful resources that can be deployed when and wherever the need arises, within the constraints of the auditor independence rules. It would in fact be perfectly possible to conduct a quality audit of a multinational company without such resources but this would be contrary to the presumptions of auditing

standards, the economic interests of the international networks of audit firms and the convenience of management. Instead, the presumed need to have such a network is allowed to remain a very significant barrier to entry into the large company audit market.

8. This is far from an exhaustive list of distinguishing features of audit market, but it is enough to show the nature of the systemic problem with audit. Auditing and accounting standards; the business model of audit firms; the liability regime; the individual interests of investors, lenders, management and audit committees: these and other features all work together to give us an system which favours consolidation and discourages innovation and competition, and whose output is increasingly what might be labelled as "compliance" with a reporting regime which meets the public's expectations to only a partial extent.

9. The audit partners and staff who work in this system are, with only rare exceptions, conscientious, diligent and highly skilled professionals who seek to make the system work, and are rewarded for doing so. It is no criticism of them to observe that the system fails to achieve what those outside the system would like it to achieve. In fact, criticising auditors or individual audits undertaken within the present system distracts attention from the real issue, which is the inadequacies of the system.

10. Of the separate features of the system summarised above, there is no single one which dictates its overall character, nor is there a clear-cut chain of cause-and-effect. The different features fit together and support each other, and the system functions as a whole. Consequently, it is hard to see how incremental adjustment to individual features will succeed in making significant change to the system. Reform of the liability system and control of restrictions in bank covenants are probably the most immediately helpful things that could be done, but even these are removal of barriers rather than positive inducements to change.

11. Moreover, there is a long history of unsuccessful attempts to improve the situation from within. For example, the "expectations gap" between what the public want and what auditors do has been around for as long as auditors can remember. Despite the profession's heroic efforts to educate the public to want less, the gap remains. And attempts to improve regulation by doing more of the same have made things better in some respects and worse in others.

12. The regulation of audit and accounting is increasingly international and the features of the audit system described above are broadly similar in all major jurisdictions. This provides a further constraint on the UK's ability to achieve significant change through adjustment of the present system. So while it might be tempting to suggest, for example, that matters could be improved by a transformation of audit regulation, this would be at least a lifetime's work if it had to be done on the international stage.

13. When the system of audit is looked at in the round in this way, if leads to the conclusion that if, as a society, we wish to see audit move away from compliance and contribute more to economic stability by increasing public understanding of and confidence in matters such as the quality of management and the sustainability of business models, and if we wish to see a market which encourages rather than discourages new entrants and innovation, we must consider radical options that could be implemented in the UK without needing international agreement. For example, any or all of the following:

13.1. Leave the financial statement audit regime largely untouched and consistent with international practice, thus avoiding getting drawn into international dispute. Meanwhile, in recognition of the fact that the expectations gap relates largely to qualitative and forward-looking information, develop the requirements for narrative reporting by UK listed companies and other public interest entities, with a view to reducing, if not closing, the gap. This narrative reporting should be audited, but not by the financial statement auditor. The audit's output should be a long-form report giving a qualitative commentary, rather than a "yes or no" opinion. Liability should be much restricted to encourage effective communication around difficult issues for which there is often no clearly right or wrong answer. Regulation should focus on ensuring that the quality of this review was apparent through the content of the report. This framework would create a new market in which innovation and specialist smaller firms would be able to flourish, so long as the visible quality of their work justified it.

13.2. Remove the statutory requirement for companies to have a financial statements audit and instead increase the requirements for boards to explain how they have ensured that they are giving a good statement of account to their shareholders. One of the problems with audit is that the duty of auditors is to report to the shareholders on the board's statement of account but they are in practice appointed and overseen by the board (the principal/agent problem). Without a statutory audit to muddy the waters, shareholders should increase their emphasis on the accountability of directors. In many cases, this could be expected to result in boards choosing to appoint auditors for their own protection. Auditors would thus be appointed by the beneficiaries of their work, who would also be those best placed to monitor its quality. If investors felt strongly enough about it, they could form a shareholders' committee to appoint and manage auditors on behalf of all shareholders (with audit fees to be paid by the company and reported in the same way as dividends, and liability negotiated under contract). This proposal would have the additional benefit of mitigating the consequences if a large audit firm were to withdraw from the market.

13.3. Distinguish the audit of consolidated accounts for shareholders from the local audits of statutory accounts of subsidiaries, by prohibiting the group auditor from acting as the auditor of all but the most material subsidiaries. This would have two benefits: it would remove a barrier to entry by taking away the perceived need to have a well-integrated international network, and it would force the auditor to address a multinational company's financial reporting by reference to how well it is managed in the context of the risks arising from its business model, rather than on its compliance with accounting standards around the world

14. This is far from a complete review of the wide range of topics covered in your request for evidence, but we hope it is sufficient to make the case that improving our system of audit will not be achieved by tweaking it. It has been tweaked at regular intervals for decades and the outcome is always to make the present system work better on its own terms. If we wish to make it work well on different terms, terms which are better fitted to the present needs of society, then we need to be willing to think outside the present system.

24 September 2010

Letter from the Institute of Chartered Accountants in Australia

The Institute of Chartered Accountants in Australia (Institute) is pleased to have the opportunity to respond to the above Call for Evidence. The Institute is Australia's premier accounting body, which represents over 50,000 professional accountants. Our members work in diverse roles across public practice, commerce, industry, government and academia through Australia and internationally.

The Institute is a founding member of the international accounting coalition called the Global Accounting Alliance (GAA), which provides reciprocal arrangements with ten of the other leading accounting bodies in the world. The Institute is the only Australian accounting body within the alliance. The GAA represents more than 778,000 members world-wide and includes professional accounting organisations from America, Canada, Hong Kong, England/Wales, Ireland, Scotland, Japan, Germany, New Zealand and South Africa.

We have limited our comments in this response to the issues and questions where we believe we can substantially add to the richness of the evidence and to provide a non-European perspective. We have not reflected on many of the questions relating directly to the banking crisis of 2008. Australia was at the periphery of the crisis but did feel the waves of impact primarily through fragmentation of the global funding markets. Our banking and financial systems served us well during the crisis.

The scale of international financial market activities has grown substantially over the last ten to fifteen years. In particular the growth of cross-border financial activity is even more rapid – international capital flows have been increasing at over 10 per cent a year over the last fifteen years. As business and the financial markets have grown and become more international there has been a strong desire from parts of the business community to have one audit firm – across many jurisdictions – meet their needs. This desire has been a strong incentive to some firms to continually build their global size.
In setting a context for our response, we wish to outline three particular themes which we believe are important to consider:

- Future of Audit – the global events of recent years have shown that there is more work to be done by all stakeholders to contribute to identifying, analysing and responding to 'systemic risk'. Systemic risks stem from the size and complexity of institutions and their relationships with other parts of the financial systems. Many and varied proposals about systemic risk have been brought forward. An auditor's current practice with its clients is to identify risk within the company. However it can be seen looking forward that there will be much greater emphasis at country level as well as industry and company level on business risks. Auditors are well placed to be involved with the reporting on risks to the business model and the potential for that model to fracture.

- Continuous Assurance – enabling technology now permits business to be conducted 24 hours a day, every day of the year. While this dramatic change has occurred in the business environment, the financial reporting and assurance model continues to focus on the past, reporting in accordance with a historical financial reporting framework. In our view there is merit in exploring changes to this model to permit 'closer to the event' assurance in

order to align the assurance model more closely to the business model. The term 'continuous assurance' is used to describe such a model. It may well be that this type of assurance is complementary to, but does not replace the current historical financial reporting framework. We attach a copy of our recent thought leadership paper on continuous assurance.

- Audit Quality – Shareholders, company directors, audit committee members, auditors and regulators all agree that quality external auditing is fundamental to capital market confidence. In just a few years the concept of audit quality has evolved from being a relatively static concept, loosely discussed and poorly acknowledged to having 'real' substance and understanding. The pace of evolution of Audit Quality is accelerating and there are great opportunities for the audit firms and professional bodies to influence the ongoing enhancement for the benefit of all. For example in recent years there has been significant work in clearly understanding the drivers of audit quality. That work is then used by participants and stakeholders with the common goal of continuing to improve audit quality. We produced *The Benefit of Audit – A Guide to Audit Quality* based upon the drivers to enhance communication (in plain English) between the audit committee and the external auditor – it has been well received. We attach a copy of our Guide.

Australian Treasury noted earlier this year that our audit regime compares well with international best practice and that the audit regulatory framework appeared to be functioning effectively during the current uncertain economic conditions. We believe that the above three themes are of sufficient importance that we will be investing substantial resources in their further development.

Finally, in presenting an Australian perspective, it is important to recognise the presence of Professional Standards Legislation in our regulatory framework that places limits on the liability of auditors. This is important in keeping audit attractive to providers, because of its impact on reducing the incentive or the need for auditors to exit public practice, as well as reducing the barriers to entry. It is also an essential driver of overall audit quality and in ensuring that the market continues to receive quality audit services.

September 2010

Memorandum by the Institute of Chartered Accountants in Australia

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Responses to specific questions

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

The emergence of four major audit firms over the last ten years is due to a number of factors. Firstly the increasing globalisation of business and clients' preference for engaging one firm of auditors in all the jurisdictions in which they operate. Clients do value all of their operations being subjected to independent external audit using the same approach and methodology. The globalisation of business has also led to dominance of certain providers of other types of commercial activities – outside of auditing – such as investment banks.

Secondly the rapid demise of Arthur Andersen in 2002 left a considerable limit on audit firm options.

Thirdly the ascent of significant engagement and public commentary by audit regulators has led to some rationalisation of audit providers. Some practitioners in Australia have considered it more beneficial to change their business models to move away from auditing services to the delivery of other types of accounting services. We have seen a contraction in the Australian market of audit firms and registered company auditors.

However, the first question being asked could infer that only the four major audit firms are capable of servicing multinational clients. The Institute's experience is that this is not the case, and many firms other than the four majors can, and do, provide quality auditing services to multinational clients.

2. Does a lack of competition mean clients are charged excessive fees?

Whilst the Australian listed market's audits are dominated (by market capitalisation) by the four major firms there are approximately 100 different audit firms currently engaged with a listed client. There is not a lack of competition amongst audit firms in Australia. There is strong contest around audit and current evidence showing aggressive fee reductions to encourage clients to change auditors or incumbent auditors to retain clients.

This strength of fee competition has recently led our audit regulator to take certain actions to preserve the delivery of quality auditing. The Institute has warned our members that audit files of entities which have changed auditors and where a substantial fee reduction is evident, will attract closer scrutiny under our quality review program to ensure fee reductions do not lead to a reduction in audit quality.

5. What is the role of auditors and should it be changed?

Notwithstanding many years of work on the clarity of communication, the role of external auditors in general is not well understood by many stakeholders – even by groups who have regular on-going contact with their auditors. The 'expectation gap' ie the differences between what auditors do and what stakeholders perceive they do is very much alive – and potentially growing wider. The statutory audit report – a primary output of an audit – is important to stakeholders in terms of the fundamental assurance it provides, enhancing the credibility of information reported on. However the current model of audit needs to change and expand. Part of this change lies in the general annoyance that audit is seen to be only focused on the past and 'why didn't the auditor see this beforehand?'

The role of the auditor has been, and continues to be, to provide an independent professional opinion on whether the financial statements of the entity present fairly the entity's state of affairs and financial results for the period. The financial position and operating results directly reflect the results of the decision of management and the Board of Directors of the entity.

We believe that the role of the auditor should be expanded to focus on:

(i) the reporting of risks to the business model and

(ii) 'closer to the event' assurance.

We have outlined these themes in more detail in our opening comments to this response.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

As mentioned above, it is not currently the responsibility of auditors to assess and report on risks to the business model. That area has clearly been the responsibility of the entity's Board of Directors and management. However if that role of the auditor could be expanded we believe that it would assist with the identification of systemic risk and the supervision of the banking sector.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

Conflicts of interest can arise between audit and consultancy roles being performed by the same audit firm. The conflicts could be real or perceived. However the main issue here is how the firm and individual practitioner identify and responds to those conflicts.

Our members of the Institute are obliged to comply with the IFAC *Code of Ethics for Professional Accountants.* The Code is principles based and adopts a 'threats and safeguards' approach to potential conflicts of interest. There are a range of responses that a firm may use with different circumstances including not accepting work or terminating an engagement if a conflict arises. Furthermore, some jurisdictions have prohibited specific activities or relationships which are considered to impair auditor independence.
In Australia the *Corporations Act 2001* prohibits audits being undertaken where certain conditions are present.

With the increasing focus on conflicts of interest, audit firms have invested heavily in developing systems, policies and processes to record and identify any potential conflicts of interest. They also have well developed approaches to responding once a conflict is identified. Also with the ascent of audit regulators in recent years, a considerable amount of their work has been focused on understanding how the independence of audit services is delivered and the focus on conflicts of interest. All of these initiatives have added greatly to managing conflicts of interest.

Also we would bring focus onto the important role that the Audit Committee has to play in monitoring any non audit services that may be provided by the auditor's firm and determining whether there any threats to the independence of the auditor. The Audit Committee must work with their external auditor to ensure that conflicts of interest – real or perceived – are managed appropriately.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

The role of internal audit is an essential contribution to the accountability and governance arrangements of a company. It plays an essential function of being 'the eyes and ears' for the audit committee. Our analysis shows that there are a number of areas of better practice in

the way internal audit operate and those should be further developed and adopted. For example the reporting lines for internal audit should be appropriate and there should be clear alignment and integration with risk management practices.

Also the role of the internal auditor could become even more effective if the current reporting and assurance model is supplemented by closer to the event assurance. Our thought leadership paper *Continuous Assurance for the Now Economy*, suggests that

". . . the emerging field of Continuous Assurance attempts to better match internal and external auditing practices to the reality of the IT-enabled entity in order to provide stakeholders with more timely assurance." The paper further suggests that most large organisations have several audits (internal, fraud, compliance, quality assurance, Basel II) which often have different structures and platforms and do not share findings. *"Rationalisation of these audit-like functions, closer coordination and technology integration with external audit, and common platforms for audit/compliance, etc would create efficiencies and substantial improvement in the handling of risk."*

As more experience is gained in closer co-operation it is likely that the audit model will evolve to extend reliance on the work of internal auditors in certain circumstances.

We believe there is great benefit in exploring this thinking for the role of internal audit further.

13. Should the role of audit committees be enhanced?

An independent audit committee is a fundamental component of a sound corporate governance structure. Importantly it brings together in one place non-executive directors, management, external audit, internal audit and advisors. The role of the audit committee has evolved significantly in the last ten years and will continue to evolve. It has moved from being a fairly limited function primarily focused on the completion of the audited financial statements to a much broader and integrated focus of responsibilities. Drivers of this evolution include regulatory expectations, market expectations and better practice initiatives members and auditors gain in closer working relationships.

<u>We believe that further enhancements can and should be made to the role of the audit committee</u>. An essential element of the audit committee's role is to interact effectively with the external auditor towards obtaining a quality audit. In order for this to happen the audit committee needs to be equipped to understand what a quality audit entails and to engage with their auditor meaningfully. We are assisting with this goal and have a range of initiatives underway to assist the director and audit committee community. To support these initiatives we have used *The Benefit of Audit: A Guide to Audit Quality.*

We also believe some further analysis needs to be undertaken about potential 'barriers' to effective audit committees and how those barriers may be overcome. This could include what potential changes could be made to the law (if any) to allow auditors to provide more meaningful reports for the better performance of the audit committee.

Communication between auditors and the audit committee is important, as is communication between the audit committee and the company's stakeholders. In our view there is merit in exploring an enhanced role for the audit committee in external communication and contributing to an improved understanding of what auditors do.

14. Is the auditing profession well placed to promote improvement in corporate governance?

Yes. In short, the training and experience auditors receive make them invaluable in promoting improvements in corporate governance. In addition it is the auditor who is able to engage with a client in a close and meaningful way but still retain that view of independence – that is a rich and unique perspective.

The IFAC *Code of Ethics for Professional Accountants* is the foundation on which the work of professional accountants and auditors is constructed. More particularly, the Code embodies the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour, which are integral in all the professional work undertaken by auditors.

The auditing profession in Australia already makes a substantial and broad contribution to improving corporate governance practice and that contribution should be developed further for the benefit of all.

September 2010

Memorandum by Institute of Chartered Accountants in England and Wales

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INTRODUCTION

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to submit evidence in response to this House of Lords Economic Affairs Committee inquiry.

ICAEW is committed to working with Government and regulators as well as wider market participants in order to help maintain economic confidence. Our 134,000 members work across every sector of the economy leading and advising organisations of all sizes. They include auditors, executive and non-executive directors, investors, regulators and wider market participants. By drawing on their collective expertise we are well placed to comment on the issues raised by the Committee.

BACKGROUND

While it will take a number of years before the causes of the financial crisis are fully understood, evidence to date indicates that it was caused by a combination of sub-prime

lending and a dramatic fall in property prices in the US. The collapse in confidence across capital markets that followed was fuelled by doubts about the viability of financial institutions holding significant assets that depended directly or indirectly on property lending or wholesale market funding.

Concerns about the relative strength of the capital base of these institutions led to a meltdown in the liquidity available to them, which cumulatively resulted in a sharp contraction of funds available to the banking system generally and the ability of banks to provide credit to consumers and businesses. As financial institutions have come under pressure from regulators to restore capital ratios to prudent levels this has continued to limit the amount of lending that is taking place, resulting in a significant decline in economic activity.

The speed at which all this happened was dramatic. A number of well known financial institutions were swept away, amalgamated or nationalised. Governments across the world were forced to underwrite failing industry sectors at a cost of many billions. Orthodoxies that governed economic behaviour over the previous decade were thrown into question. The real economy is only beginning to move from recession to fragile recovery.

In these circumstances it is right that our financial systems be scrutinised. All market participants need to think hard about the lessons of the past two years and be prepared to take the necessary steps to ensure that the risk of this happening again is mitigated.

The audit profession, which plays an integral part in the effective operation of capital markets and the wider economy, is no exception.

The past 24 months have tested auditing reforms adopted in the UK after Enron as well as the work undertaken through avenues such as the Audit Quality Forum. The evidence to date suggests that in the main, auditors have been performing an important role with diligence in the face of challenging economic circumstances and that recent reforms are holding up well.

Part of the auditors' contribution has been to challenge asset valuations, which has contributed to companies having to revalue their assets, in certain cases requiring a considerable reduction in values in order to give a true and fair view in accordance with the relevant financial reporting framework. These revaluations have contributed to the falling financial performance of banks, reductions in share price and criticism of their directors in general meetings of shareholders as well as the media.

However, over the past 18 months ICAEW has been examining what lessons can be learnt from the crisis and how audit needs to evolve to meet changing market expectations. Our Financial Services Faculty has led on this work. Key recommendations are included in the report *'Audit of banks: lessons from the crisis'* which we have appended to this submission. In particular, we believe that improvements can be made in terms of the way risk is reported by banks. We also think there is a need for better dialogue between auditors and bank supervisors. To this end and at the request of the Bank of England we are participating in a Working Group to look at the flow of critical information on banks between the regulator and auditors.

This House of Lords Committee inquiry is a timely and important contribution to the current debate. It builds on the Committee's June 2009 report into Banking Supervision and Regulation to which ICAEW also submitted evidence.

Three key points inform our written submission:

- This has not been an audit driven crisis and UK audit quality remains world leading.

- The audit profession, along with other market participants, must nonetheless reflect on what lessons can be learned from what has happened over the past two years.

- This has been a global crisis and reform proposals must therefore be capable of implementation across markets.

UK audit firms belong to international networks and audit UK businesses that are international in their operations. We urge the Committee to ensure that hasty responses to the current crisis at the national level do not inadvertantly sow the seeds of a future crisis.

ICAEW has been invited to give oral evidence to the Committee in October when we will be happy to expand on any of the points set out in this submission.

RESPONSES TO SPECIFIC TERMS OF REFERENCE

Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1. The current concentration of firms providing audit services to the listed company sector has largely been driven by the behaviour and economic choices of these companies as well as the growth strategies of these firms.

2. When the audit committee of a listed company looks to appoint an auditor, what drives this choice is the need to ensure that the firm has the necessary breadth and depth of expertise. Those who appoint auditors should not be motivated by the need to ensure diversity in the audit market but the need to ensure auditors do the best job for their shareholders. From the perspective of the individuals who make these appointments there are incentives to gravitate towards an internationally recognised brand with the global reach that this brings.

3. While greater choice across the FTSE audit market is clearly something we would welcome what matters ultimately is that audit quality remains high.

4. This issue of market concentration has been looked at by the UK Government and the European Commission both of whom commissioned independent research[2] in this area. It was also examined by the Audit Quality Forum, whose work fed into a two year project undertaken by the Market Participants Group (MPG) of the Financial Reporting Council. The MPG identified a range of long-term, market driven steps that could be taken to increase competition and choice which are now being implemented. It is too early to assess

[2] Oxera Report and London Economics Report

the impact of these measures (the Audit Firm Governance Code for example was only introduced earlier this year) and they should be kept under close review. It is also worth noting that the European Commission is likely to revisit the issue in its forthcoming Green Paper on audit.

5. Economies of scale certainly create barriers to entry. The Oxera report made the point that 'any new entrant would need to overcome perception barriers and demonstrate sector-specific skills, international coverage and high quality staff to win audits'. This is not easy given the difference in size between the four largest firms and other major international networks. Other barriers also exist. For example, the European Union's Directive on statutory audit sets certain minimum control requirements for audit firms. These may prevent external capital providers funding a smaller firm as it seeks to become larger.

6. It is also important to remember that the current situation has arisen through market demand with the largest firms growing their audit services to meet the global needs of their clients. In many ways this process has been a success story for the UK economy as the UK arms of the dozen or so largest international network firms as well as many of the mid-tier practices have been at the forefront of driving quality, innovation and capability in this industry sector.

Does a lack of competition mean clients are charged excessive fees?

7. No. We are not aware of any evidence to support a claim that audit clients are charged excessive fees. While there are relatively few firms currently serving the listed company sector those that serve the market compete fiercely with each other on price as well as other differentiators. Competitive tendering or the threat of it across this sector ensures the firms are kept on their toes.

Does a narrow field of competition affect objectivity of advice provided?

8. No. In our view the competitive structure of the current audit market does not have a significant bearing on auditor objectivity. Of far greater significance is the investment in training and development within the firms and the professional standards and ethical codes to which auditors must adhere, as well as the regulatory and oversight regimes that are currently in place to ensure that quality and objectivity are maintained. The learning and professional development students must undertake in order to qualify into the profession requires them to develop a range of skills in ethics, professional judgement and scepticism intended to ensure the objectivity of their work.

9. In January 2010 the FRC and ICAEW published the Audit Firm Governance Code. The Code applies to eight audit firms that together audit about 95% of the companies listed on the Main Market of the London Stock Exchange. For these firms, the Code sets a benchmark for good governance which other audit firms may wish to voluntarily adopt in full or in part and requires explanation for non-compliance. The Code sets out expectations of the role of independent non-executives in the firms' governance structures. It also codifies much existing good practice and references matters that audit firms must comply with as regulated professional partnerships.

Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

10. No. Again we would argue that the competitive structure of the current audit market does not have a significant bearing on auditor objectivity. Auditors are subject to significant independence requirements which are designed to protect objectivity and the ability to challenge and disagree with directors' opinions.

What is the role of auditors and should it be changed?

11. Auditors give shareholders confidence that financial information reported by a company is 'true and fair'. They do this by following a process whose standards are set and enforced by independent regulators. The role of auditors under UK law is explored in detail in the Audit Quality Forum publication *Audit Purpose* which is available on the ICAEW website at www.icaew.com.

12. An audit does not provide absolute assurance about the state of a company's financial health. The operation of a business involves judgements on a wide range of areas and this brings with it risk. No matter how strong financial reporting, auditing and corporate governance measures may be, they cannot eliminate bad business models or poor judgements by directors.

13. In the wake of the financial crisis all market participants need to reflect on what lessons can be learned to help mitigate the risk of these events happening again. To this end ICAEW has recently published a set of recommendations for improving the audit of financial institutions, *Audit of Banks: Lessons from the Crisis* published in June 2010:

Bank reporting
Risk information is often presented in a piecemeal manner in bank annual reports, spread between the audited financial statements and the unaudited front sections. Banks need to focus on clearer presentation which allows users to understand the big picture, which is currently often obscured by the volume of detailed information. Summary risk statements are a potential way of providing this big picture. Auditors should be asked to provide assurance on new summary risk statements to provide confidence to readers of financial statements.
Audit committees have an important role to play in supporting better reporting. Auditors play a key role in making sure audit committees are equipped with the information they need to perform their role. A guide to good practice in audit committee reporting would help improve performance.

Auditor reporting
Insufficient information is provided under the current framework about the work that underpins an audit. This makes it difficult for investors to assess the performance of bank auditors or to understand the key areas of challenge. To address this gap, banks should confirm that key areas of judgement discussed with auditors are set out in the critical accounting estimates and judgements disclosures in the financial statements. Our Financial Services Faculty is setting up a forum for investors and auditors to help make the audit

more transparent. Auditors should also have more involvement in reporting on the front sections of annual reports. Their responsibilities for this are currently very limited.

Dialogue with supervisors
Regular exchange of information between auditors and bank supervisors enables both parties to perform their duties more efficiently and effectively. Dialogue between auditors and banking supervisors was not consistently good enough before the crisis, with the regulator not placing sufficient value on such dialogue. There have been improvements in both the frequency and quality of dialogue but this remains variable and is dependent upon the attitude of individual supervisors. Further improvements are needed, including improvements to promote greater consistency between supervisors and ensure that discussions are a two-way process for information sharing.

Support for supervision
Auditors and other external experts have particular skills that can support banking supervisors in performing their functions. Supervisors have the power to utilise these skills but have done so rarely, typically only where particular problems have been identified. There is scope for making greater use of external experts on a thematic basis, as part of supervisors' overall monitoring regime and as preventative or diagnostic measures.

Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

14. Notwithstanding concerns expressed recently by regulators we have seen no hard evidence to support claims that auditors were not exercising a high degree of professional scepticism in the run-up to the financial crisis whether as a result of a lack of competition or any other factor. Successive reports from the independent Audit Inspection Unit (AIU) have indicated that UK audit quality remains high.

15. The increased number of going concern qualifications and 'emphasis of matter' modifications in audit reports over the past two years[3] suggests that auditors have continued to push back where they felt the need to do so.

What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

16. Auditors were operating in the same environment as other market participants including regulators and Government and, like these other market participants, did not anticipate the systemic collapse in confidence across the capital markets that was fuelled by doubts about the viability of certain specific financial institutions. As the House of Commons Treasury Committee (TSC) concluded in May 2009 'we have received very little evidence that auditors failed to fulfil their duties'[4].

[3] Deloitte research
[4] Treasury Committee Report: Reforming corporate governance and pay in the City', 15 May 2009, paragraph 221

17. The banking crisis did however highlight weaknesses in the level of dialogue between auditors and bank supervisors. Meetings between auditors and the FSA were too infrequent, the range and quality of information shared by bank supervisors with auditors was limited, and the FSA had no obligation to share relevant information with the auditors. In hindsight, better channels of communication may have helped mitigate some of the effects of the crisis.

18. The need to improve the level of engagement has been acknowledged by the FSA and this has been improving since the start of the crisis.

19. Moving forward, auditors have an important role to play in better supervision of the banking sector. Auditors and other experts have particular skills that can assist banking supervisors in performing their functions.

20. As part of the improved dialogue between auditors and supervisors there needs to be a better balance of information shared. Currently there is a duty on auditors to report matters to the FSA which may be material to their supervisory responsibility but no corresponding duty on the FSA to share information with auditors that may be material to the audit. It would also be helpful for auditors to raise concerns with senior management within regulators if they consider the level of engagement from the supervisory team is inadequate.

21. To support the regulator in its supervisory work auditors could look at areas of risk in greater detail during the audit. Under section 166 of the Financial Services and Markets Act (FSMA), the FSA can commission a report to be prepared by a 'skilled person' (s166 reports). Skilled persons include bank auditors. These reports could be used by the FSA on a thematic basis, or as a diagnostic and monitoring tool where the regulator is seeking to identify risks or problems in the system, or in assessing performance or compliance. The resulting exchange of information could be a powerful tool in the better supervision of banks.

How much information should bank auditors share with the supervisory authorities and vice versa?

22. As a guiding principle, bank auditors should be prepared to disclose anything to bank supervisors and vice versa. How this can be achieved in practice is something ICAEW is currently working on with the Bank of England, the FRC, the FSA and the major audit firms.

If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

23. There are already very strong incentives for auditors to be objective. They report in accordance with independently set standards on the truth and fairness of financial statements, adhere to rigorous independence and ethical requirements and are subject to regulatory oversight. All of these requirements act as a check and balance on the professional judgement that they exercise. In recent years the AIU has also reported annually on the quality of individual firms, providing another important incentive for auditors to be objective.

Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

24. Yes. Conflicts of interest are one of a number of potential sources of threats to auditor independence which arise as a result of self-interest, self-review, advocacy, familiarity and intimidation. These threats are dealt with through effective disclosure as well as a regime of safeguards, selective prohibitions on consultancy services and, crucially, review by the audit committee, which is central to UK corporate governance.

25. There will be always be specific circumstances where the provision of non-audit services is unacceptable and ICAEW believes the current framework should be kept under constant review. However, there is no evidence that the provision by auditors of non-audit services to listed entities that they audit has actually compromised audit quality and we do not believe that the provision of these services diminishes audit quality. Our understanding is that the overwhelming majority of respondents to the current Auditing Practices Board (APB) consultation on non-audit services see the current regime as largely effective and reject outright prohibition of non-audit services as proposed by the TSC in favour of better disclosure provisions.

Should more competition be introduced into auditing? If so, how?

26. As a general principle we support greater choice in the audit market. We also believe the current industry structure is the result of market dynamics which would limit the effectiveness of any direct market intervention. Market based measures such as those set out by the Market Participants Group of the FRC should prove most effective and durable over time.

Should the role of internal auditors be enhanced and how should they interact with external auditors?

27. Yes. Internal auditors should have a leading role within an organisation in providing assurance on the management of risk. The remit of internal audit should, in theory, be very wide-ranging across all parts of an organisation. Although its role is set by the board, the audit committee and management, in practice what internal audit can actually achieve is limited by resources and expertise. Their work should be focused on areas of greatest risk within the organisation which often go well beyond financial risks and controls.

28. The relationship between internal and external auditors is established by standards for external auditors. It is good practice, even if external auditors decide not to use the work of internal auditors, for there to be good communication between the two functions. Internal audit can be a useful source of information about the risks and controls within the organisation and how management are addressing these issues. However, external auditors do need to remember that internal auditors are responsible to companies and not investors and be mindful of this distinction.

Should the role of audit committees be enhanced?

29. Yes. Audit committees have a vital role to play in terms of promoting good corporate governance and in challenging management. Their responsibilities have evolved over time and been considered again by the Walker Review on Corporate Governance in Financial Institutions, and also by the recent wider review of corporate governance conducted by the Financial Reporting Council. In particular we would support more information being made

available by audit committees about their discussions with auditors, to provide evidence that auditors are performing their duties with due rigour, to ensure wider stakeholders are better informed about the way in which audit committees handle their governance responsibilities and to provide greater clarity around the nature of the judgements the company has made in the accounts.

Is the auditing profession well placed to promote improvement in corporate governance?

30. Yes. Although it is for companies themselves to determine their governance structures, auditors are an integral part of the corporate governance process and have a duty to report matters of significance and provide challenge to management's critical accounting estimates. This normally happens through the audit committee.

31. ICAEW has established a working party that will publish guidance in early 2011 to strengthen the consistency and quality of communication between auditors and bank audit committees. This will improve corporate governance in banks, as it will enable audit committees to better challenge executive directors on accounting judgements and estimates and financial statement presentation.

24 September 2010

Institute of Chartered Accountants in Scotland

INTRODUCTION AND KEY POINTS

Introduction

The Institute of Chartered Accountants of Scotland welcomes the opportunity to submit evidence to the House of Lords Economic Affairs Committee inquiry on Auditors: Market Concentration and their Role.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key Points

- This is a global issue and is not restricted to the UK listed company audit market.
- We do not believe that there is a lack of competition in the listed company audit market but rather that the level of market concentration is not dissimilar to that

found in certain other sectors. However, we do believe that if the level of competition was to contract further, for whatever reason, that there would be a problem. We therefore believe that it is imperative that a change to the auditor liability regime is made in early course. Auditors should only be held accountable for their share of the blame in relation to any successful negligence claim against them and that is why we favour the introduction of a mandatory proportionate liability regime.

- An ICAS Working Group is currently considering the role of the auditor and whether this needs to be developed further. Recent research[5] has indicated that there is significant demand from the investment community for at least some degree of external assurance on the management commentary section of the annual report. The Working Group's report is expected to be published before the end of the year and we will send a copy to you as soon as it is finalised.
- We do not believe that the level of competition has any impact on the objectivity of the auditor.
- We believe that the role of the audit committee is already well established within the listed company sector. It is our belief that it is the composition of the audit committee and the diligence of its members which is key. We do, however believe that there is a greater need for transparency over the work of the audit committee. Current reporting requirements on the work of the audit committee can often result in "boilerplate" disclosures which add little to the stakeholder's understanding of their role and their interaction with the external auditors. The audit committee plays a critical role in challenging management's judgements and more disclosure in the audit committee report could further the transparency of both the external audit process and the internal assurance processes within a company.
- We believe the non-mandatory approach to internal audit to be appropriate. However, we also firmly believe that it is beneficial for listed companies to have an effective internal audit function. In order for the internal audit function to be effective it must have support at board level and not be seen as a mere compliance related function.

- It should be noted that there are various different Government, regulatory and professional bodies currently reviewing the role of the auditor. These include, but are not limited to the following:

  (i) the European Commission which is expected to publish its Green Paper on Auditing, in October.
  (ii) the Financial Services Authority/Financial Reporting Council in their joint discussion paper 10/3 "Enhancing the Auditor's Contribution to Prudential Regulation".
  (iii) the Auditing Practices Board in its discussion paper "Auditor Scepticism: Raising the bar".
  (iv) the ICAS "Future of Assurance" Working Group which comprises stakeholders from the investment community, industry, academia, the media and the profession.

[5] ICAS (2010), Meeting the needs? User views on external assurance and management commentary, http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=6852

We would therefore encourage the Committee to also consider the findings of the above consultations/projects before finalising its recommendations.

RESPONSES TO SPECIFIC QUESTIONS

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

Accountancy firms are businesses and like other businesses, firms have merged for similar reasons to mergers which have taken place in other sectors. The current market position arose over a number of years and as a result of various factors which we outline below. It needs to be highlighted that this is a global issue and is not unique to the UK listed company audit market.

A number of major industry sectors have only 4 or fewer major dominant players. This does not necessarily indicate that a lack of competition exists e.g. the record industry in the UK only has four major players, there are four main food retailers in the UK, and the global private aircraft manufacturing sector only has two. Whilst we appreciate that in certain niche sectors entities may be restricted to less than four accountancy firms from which to choose their auditor, the vast majority of listed companies have access to greater choice. Additionally, for non quoted companies there is plenty of choice in the audit market.

The factors which have led to the current level of concentration in the listed company audit market can be summarised as follows:

(i) Growth of multi-national companies – responding to customer needs

As companies began to expand their respective operations beyond their domestic markets, professional accountancy firms did likewise to enable them to provide the necessary services to support their clients. This client driven expansion partly explains the larger accountancy firms' initial international expansion which was effectively driven by the needs of British and US based multinationals for worldwide service in the 20th century. The larger accountancy firms responded:

(a) by forming local partnerships in different jurisdictions or
(b) by forming networks with local firms already in existence in the particular jurisdiction concerned.

Even fairly recently, due to business demand, auditors needed to establish operations in China, where there was no established accountancy profession.

(ii) Quality

Linked to (i) above, is the need for an audit firm to be able to satisfy itself in relation to the quality of work undertaken, regardless of which jurisdiction the work is performed. Where clients had sizeable operations in different countries it was more difficult for audit firms to ensure the quality of audit work in such jurisdictions where the audit of some client affiliates (subsidiaries, associates etc) was undertaken by firms not connected to the parent company

auditor. The need for the parent company auditor to ensure that firms in different countries audited to the same standards resulted in the establishment of networks to allow the sharing of knowledge, agreed methodologies, training requirements and quality assurance etc. It also made it easier to control the group audit when all significant affiliates of the company were audited by a member firm of the network. In this respect many clients would also rather only have to deal with one firm auditing all of the group entities.

(iii) Barriers to Entry

Per the figures in Appendix 1, there is a substantial gap between the revenue of the lowest of the Big Four firms and the revenue of the next accountancy firm on the list. Therefore, a fundamental change in the market or in the legal/regulatory environment would be required to foresee a situation where a firm not currently in the Big Four was to effectively challenge the market share of even the lowest ranked Big Four firm. The barriers to entry are substantial and are briefly summarised below.

Available Resources/ Breadth of Network
In relation to servicing multi-national companies, not all networks have associate firms or sufficiently resourced associated firms in all key jurisdictions. Many large corporates therefore argue that only the Big Four firms provide the global reach that is required to service their particular operations. This will obviously depend on the nature and complexity of the entity's operations and the number of jurisdictions within which it operates, however, it is also not just the existence of a network firm in a particular jurisdiction but also the quality of the individual firms within that particular network which is key.

Litigation Risk
The auditors of large multi-national companies are potentially exposed to legal claims the size of which could threaten the very existence of the firm. In theory, the larger the size of the firm the greater access it has to resources to meet any such successful claim.

Depth of Specialism
On certain audits the depth of specialism required e.g. for the audit of a major bank, is unlikely to be present in sufficient volume outside of the Big Four firms.

Regulatory Costs
The costs of having to comply with various different regulatory regimes across the globe are a significant barrier to entry for firms seeking to break into the listed company audit market.

(iv) Growth by Merger/Acquisition

Over the years many smaller firms have disappeared as firms have merged for a variety of reasons. Up until 1989, the audit market was dominated by the largest eight accountancy firms. Following further mergers the market was left with the Big Five which became four when Arthur Andersen collapsed due to the reputational damage suffered following the demise of Enron.

(v) Economies of Scale

Undoubtedly, accountancy firms would have viewed economies of scale as a potential benefit of a merger e.g. the savings in costs in relation to developing methodologies,

systems, technical support, administration etc. However, significant costs had to be incurred to merge the working practices and systems of the firms involved.

2. Does a lack of competition mean clients are charged excessive fees?

To the best of our knowledge there is no evidence to suggest that clients are charged excessive fees. The Transparency reports produced by the larger accountancy firms show lower levels of profitability for assurance services than for other services provided. The vast majority of listed companies are in a position where they can instruct a number of audit firms and have the ability to put the audit out to tender on an annual basis, if they so wish. We do accept that in a few rare situations, conflicts of interest may restrict the choice to less than four firms due to the level of specialised knowledge required, particularly in certain niche sectors. Developments in corporate governance and in particular the increasingly important role of the audit committee also serve to prevent firms charging excessive fees. ICAS produced revised guidance in 2007 entitled: "Appraising Your Auditors"[6]. The Guide provides practical assistance to audit committees in handling the responsibilities recommended by the FRC Guidance on Audit Committees. In particular, the Guide helps audit committees in their critical roles of monitoring the relationship between company and auditor, overseeing the independence and objectivity of the auditors and, when appropriate, selecting new auditors.

Additionally, surveys of audit fees in the FTSE sector are regularly undertaken and the price charged for an audit is specifically disclosed in the annual financial statements of a company. Therefore, the fee charged for an audit is transparent and companies can benchmark the cost of their audit versus that of their competitors.

We would also like to emphasise that the audit fee must be adequate to allow a full and proper audit to be undertaken in accordance with auditing standards.

3. Does a narrow field of competition affect objectivity of advice provided?

We do not believe that the existing field of competition impacts on the objectivity of the advice provided and we are not aware of any evidence to the contrary. Objectivity is a state of mind expected of a professional and in our view is not subject to improvement by increased competition.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

As with our response to the previous question a key ethical requirement is for auditors to be objective. We do not believe that the level of competition in the marketplace is a factor in an auditor's ability to challenge his client.

[6] ICAS (2007), Appraising Your Auditors: A Guide to the Assessment and Appointment of Auditors, http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=5240

5. What is the role of auditors and should it be changed?

Role of Auditor
The role of the auditor is set out in sections 495-498 of the Companies Act 2006. This is summarised as follows:

The auditor's primary role is to report to the company's shareholders on the truth and fairness of the company's annual statutory financial statements. The auditor also has to report on the consistency of the information contained in the directors' report with that contained in the financial statements. There are other related duties which can be found at the above sections of the Companies Act 2006. For listed companies, the auditor also has to report on whether the auditable part of the directors' remuneration report has been properly prepared and additionally review certain listing rules requirements.

Role of Auditor – recent developments
Questions have been asked in recent times as to whether the role of the auditor is too narrowly defined e.g. paragraph 221 of the report of the Treasury Select Committee (TSC) 'Banking Crisis: reforming corporate governance and pay in the City"[7] published in May 2009 stated:

"We have received very little evidence that auditors failed to fulfill their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in 'tunnel vision', where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures."

Therefore, notably the TSC found little evidence to suggest that auditors had not properly performed their duties but questioned whether there was value in the audit. At a prestigious ICAS event "The Aileen Beattie Memorial Lecture"[8], held in April 2010, none of the panelists which included a senior investor representative and a FTSE 100 company executive, believed that the statutory audit should be abolished and assurance needs left to the market. They all expressed their support for the statutory audit and the role it plays although it was recognised that the auditor could be asked to do more in certain areas.

Recent research undertaken on behalf of ICAS ('Meeting the needs? User views on external assurance and management commentary')[9] identified that there is significant demand for at least some degree of external assurance on the management commentary section of the annual report. This could therefore present an opportunity for additional assurance to be provided by the auditor.

[7] House of Commons Treasury Committee (2009), 'Banking Crisis: reforming corporate governance and pay in the city', Ninth report of Session 2008/9 HC 519, 15 May, The Stationery Office Limited, http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf
[8] ICAS (2010), Aileen Beattie Memorial Event – 'Should Statutory Audit be Dropped and Assurance needs left to the Market', http://www.icas.org.uk/site/cms/download/AEB_Event_2010_Transcript.pdf
[9] [9] ICAS (2010), 'Meeting the needs? User views on external assurance and management commentary', http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=6852

It would appear that there still remains an expectation gap between what certain stakeholders believe that the auditor is responsible for and what in fact his responsibilities are. In our view, moves could be made to meet some of these expectations but there are certain expectations which we do not believe can be met. To progress this issue, ICAS established a 'Future of Assurance' Working Group earlier this year comprising representatives from the investment community, academia, the media, industry, regulators and the profession. The Working Group has now met twice and it is anticipated that it will publish its proposals before the end of the year. It is our intention to forward a copy of the final report to you once it is finalised. Matters that are being considered include the following:

(i) Could the auditor do more in terms of reporting on 'going concern'?
(ii) Should the auditor provide assurance on the front end narrative section of the annual report?
(iii) Would a more informative and discursive audit report be seen as beneficial?

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

There is no specific evidence to answer this question in the affirmative or the negative. The Financial Services Authority and Financial Reporting Council have accused the auditing profession of lacking "professional scepticism" in its recent discussion paper[10] and the APB has published a paper[11] on this topic. However, the FSA/FRC paper does not contain any specific evidence to substantiate this claim.

The auditor's role as stated above is to report on the truth and fairness, or otherwise, of the annual accounts. The auditor has to assess the assumptions and estimates made by management. This assessment is conducted against the requirements of the applicable accounting framework, with some accounting standards requiring a greater degree of judgement than others. Where management's judgement falls within the parameters of an accounting standard, it is difficult for the auditor to argue that their judgement is more appropriate than the judgement of management. Ultimately management is responsible for the preparation of the financial statements and they will naturally understand their own business in greater depth than their auditors. The auditor's role is to provide assurance that those financial statements are true and fair against the applicable financial reporting framework.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

[10] FSA/FRC (2010) Discussion Paper 10/3: 'Enhancing the Auditor's Contribution to Prudential Regulation', http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf
[11] APB (2010, Discussion Paper, 'Auditor Scepticism: Raising the Bar', http://www.frc.org.uk/apb/publications/exposure.cfm

First and foremost, the auditing profession was not responsible for the banking crisis, as has been explained in various reports which have been published since the crisis e.g. the Turner Report[12].

"At the core of the crisis lay an interplay between macro-imbalances which had grown rapidly in the last ten years, and financial market developments and innovations which have been underway for about 30 years but which accelerated over the last ten to 15, partly under the stimulus of the macro-imbalances."

Given the role of the auditor as discussed above, we are not aware of anything that auditors could have done to mitigate the banking crisis. Going forward, improvements could be made to the current regime by requiring regular meetings of all the auditors of large financial institutions with the body charged with monitoring financial stability.

8. How much information should bank auditors share with the supervisory authorities and vice versa?

As one of the issues in the years leading up to the credit crisis appears to have been the lack of meetings held between the FSA and auditors, it is essential that greater dialogue between these two parties is encouraged. It is therefore crucial that plans are introduced for regular meetings to be held to facilitate the sharing of relevant information where possible. Note we stress the "sharing of information" as we believe this has to be a "two-way" process and believe that increased dialogue can assist both parties in discharging their duties appropriately. Whist we have support for the concept of the proposed default position proposed by the FSA/FRC. "Both parties need to learn that, where there is a concern, the default should be to share the information unless there are restrictions that would prohibit this." we have concerns that there would still possibly be situations where the auditor is not made aware of something that might have a material impact on the audit. Therefore, in our opinion the best way to facilitate the appropriate sharing of information would be to introduce a reciprocal mandatory reporting obligation on the FSA to that which auditors are currently subject to.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

We believe that there is no need to strengthen the current framework in this respect. Auditors do provide objective and on occasion unwelcome challenge to clients. Generally, the unwelcome challenge will be acted on by the board of directors rather than run the risk of having the audit report on their company's accounts qualified. Additionally, improvements have already been made to auditing standards and these will become effective for accounting periods ending on or after 15 December 2010. Likewise, revised ethical standards for auditors will become applicable early in 2011.

[12] FSA (2009), 'The Turner Review – A regulatory response to the global banking crisis', http://www.fsa.gov.uk/pubs/other/turner_review.pdf

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

Conflicts of interest can arise in certain situations e.g. where audit firms provide non-audit services to their audit clients. The extent of the conflict determines whether or not the auditor is able to provide the service in question. Some threats may be capable of being mitigated by the use of appropriate safeguards by the audit firm e.g. use of different personnel etc whilst others cannot be satisfactorily safeguarded and therefore the service cannot be provided.

Following the aftermath of Enron et al, the Auditing Practices Board was tasked with producing ethical standards for auditors which audit firms are required to comply with. The APB published its standards in late 2004 (revised 2008) and they are one reason as to why the level of non-audit services provided by auditors to their listed audit clients has decreased significantly since 2001. The ratio of non-audit to audit services peaked in 2001 at a level around 3.1. By 2008, the ratio had fallen significantly to 0.7.

In May 2009, Treasury Select Committee[13] recommended that:

"We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity."

The APB consulted late 2009/early 2010 on whether audit firms should be prohibited from providing all non-audit services to their listed audit clients. ICAS specifically set up a Working Group, comprised of representatives from the investment community, industry, academia and the profession to respond to the consultation. The Working Group also sought the views of leading investors and directors of listed companies and issued its paper in January[14]. Out of approximately 150 responses to the APB's consultation, only 3 were in favour of a complete prohibition being introduced. Therefore, the overwhelming message was that there should not be a complete prohibition on audit firms providing non-audit services to their listed clients. Additionally, the vast majority of respondents supported the 'threats and safeguards' approach adopted by the APB in its standards. The APB however has taken the opportunity to make proposals which could further tighten up the types of the non-audit service that the auditor can provide. This consultation does not close until 23 October.

11. Should more competition be introduced into auditing? If so, how?

ICAS supports the work undertaken by the FRC in raising the matter of limited choice in the audit market for listed companies, although we appreciate the limited impact that the proposals of the Market Participants Group have had to date. It is important that this is kept to the fore and the debates over the last year have certainly focused more attention on the issue. The ICAS view remains that the overriding priority in the short-term is to ensure that

[13] House of Commons Treasury Committee (2009), 'Banking Crisis: reforming corporate governance and pay in the city', Ninth report of Session 2008/9 HC 519, 15 May, The Stationery Office Limited, http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf

[14] ICAS (2010), 'The Provision of Non-audit Services by Audit firms to their listed company clients', http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=6645

all of the big four firms remain in existence. In this respect we believe that reform of the current liability regime is urgently required. In 2007, the previous Government appeared to accept the argument for removing the "unlimited liability" regime for auditors. However, the optional contractual system put in place has had no impact on the market. There are no quick or easy measures, however, that can be put in place to bring forth another 'very large auditor' and, of course, the issue is made more difficult as it goes beyond the UK.

Other than legislation to introduce a fairer liability regime as indicated in our response in August 2006 to the FRC's initial consultation about choice in the UK audit market, we believe that this issue in general should be left to market forces. Market based measures are more likely to effect gradual and sustainable improvements than regulatory changes, which may have unintended consequences. We do not support regulatory intervention to artificially increase competition in the audit profession. As noted above the listed auditing market is not unique, there are a number of other industry sectors where the market is dominated by 4 or in some cases fewer major players. The possibility also exists that a new large accountancy firm might enter the market from one of the rapidly developing economies e.g. China or India.

We have long argued that developing and implementing proportionate liability should assist in increasing auditor choice and that this should not be at the expense of audit quality. Companies need access to quality audits at a reasonable cost but there is a high risk attached to auditing multinational companies, which is due to the auditor being exposed to potentially very high claims compared to the profits of the auditing unit concerned and this acts as a deterrent to new entrants to the multinational market.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

It should be realised from the outset that the roles of internal audit and that of the external auditors are entirely separate. The role of the external auditor as noted above is enshrined in legislation whereas there is no statutory requirement for any size of company to have an internal audit department although the majority of large listed companies do so. The role of the internal audit function is determined by those charged with governance of the organisation. Indeed the UK Code on Corporate Governance which listed companies are required to apply on a 'comply or explain' basis implies that companies complying with the Code should have an internal audit committee in the accountability section of the Code.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

We believe this non-mandatory approach to internal audit to be appropriate. However, we also firmly believe that it is beneficial for listed companies to have an effective internal audit function. In order for the internal audit function to be effective it must have support at board level and not be seen as a mere compliance related function.

Interaction with External Auditor

The matters which the external auditor should consider in situations where a client has an internal audit function are set out in International Standard on Auditing (UK and Ireland) 610 'Using the Work of Internal Auditors'[15]

"(a) To determine whether, and to what extent, to use specific work of the internal auditors; and

(b) If using the specific work of the internal auditors, to determine whether that work is adequate for the purposes of the audit."

In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:
(a) The objectivity of the internal audit function;
(b) The technical competence of the internal auditors;
(c) Whether the work of the internal auditors is likely to be carried out with due professional care; and
(d) Whether there is likely to be effective communication between the internal auditors and the external auditor."

The standard basically adopts the principle that it is for the auditor to decide to what extent he wishes to rely on the work undertaken by the internal audit function which at least to some degree will be determined by the nature of the work performed during the period by the internal audit function and the auditor's assessment of the quality of that work and independence of internal audit within the organisation. In our view this position is appropriate. We note that the International Auditing and Assurance Standards Board is currently revising this standard but we do not believe that the revision will alter the fundamental principle that it is for the auditor to decide to what extent he wishes to rely on the work of internal audit. We also support the function of internal audit as a mechanism for providing assurance within a company and as a basis for the directors to prepare their financial statements with confidence.

13. Should the role of audit committees be enhanced?

We believe that the role of the audit committee is already well established within the listed company sector. It is our belief that it is the composition of the audit committee and the diligence of its members which is key.

We do, however believe that there is a greater need for transparency over the work of the Audit Committee. Current reporting requirements on the work of the Audit Committee can often result in "boilerplate" disclosures which add little to the stakeholder's understanding of their role and their interaction with the external auditors. The Audit Committee plays a critical role in challenging management's judgements and more disclosure in the Audit Committee Report could further the transparency of both the external audit process and the internal assurance processes within a company.

[15] APB (2009)), International Standard on Auditing (UK and Ireland) 610 'Using the Work of Internal Auditors', http://www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20610%20(final)%20.pdf

14. Is the auditing profession well placed to promote improvement in corporate governance?

Auditors can provide a mechanism for improving corporate governance. In isolation it is difficult to envisage how effective an audit firm could be in this respect without support from the other constituent parts i.e. the directors and the shareholders. Auditors are ideally placed to make recommendations to those charged with governance in relation to weaknesses in the governance framework in place within an entity but ultimately such recommendations need to be acted on by the company.

24 September 2010

Appendix 1: Global Revenues of the 6 Largest Accountancy Firms for Years Ending 2009

Global Revenues

	PwC (1)	Deloitte Touche Tohmatsu (2)	Ernst & Young (3)	KPMG (4)	BDO (5)	Grant Thornton (6)
Year Ended		31/05/2009	30/06/2009	30/09/2009	30/09/2009	30/09/2009
Global Revenues	$26.17b ($26.19b)	$26.1b ($27.4b)	$21.44b ($23.00)	$20.11b (22.69b)	$5.026b ($5.144b)	$3.59b ($3.96b)
Assurance	$13.14b ($13.81b)	$11.9b ($12.7b)	$10.14b ($10.83b)	$9.95b ($10.69b)	$3.02b ($2.89b)	$1.64b ($1.71b)

Sources

(1) www.pwc.com

(2) www.deloitte.com

(3) www.ey.com

(4) www.kpmg.com

(5) www.bdo.com

(6) www.gti.org

Memorandum by the Institute of Internal Auditors

Summary of key points

1. The role and value of internal audit should be better recognised within the UK Code of Corporate Governance, and guidance issued under it by the Financial Reporting Council (FRC), with regard to publicly listed private sector organisations. This would bring the private sector into line with best practice in the public sector.

2. At the same time, we would like to see a clearer understanding of the differences between external audit and internal audit and an appreciation of the different contributions they can make.

3. Audit committees have a vital role to play in supporting internal audit quality. The FRC's Code of Corporate Governance and the supporting Guidance for Audit Committees should require audit committees to satisfy themselves in relation to the competency, confidentiality, independence, objectivity, security of resources of internal audit and of the effectiveness of the relationship between internal audit and the audit committee.

4. Regulators in general should give greater recognition to the assurance that they can take from the work of a professional internal audit function.

5. The breadth and scope of internal audit's role means that it has a significant role to play in supporting the organisation to improve corporate governance.

6. Accounting firms should not provide internal audit services to their external audit clients.

The Institute of Internal Auditors

7. Established in the UK and Ireland since 1948, the Institute of Internal Auditors – UK and Ireland has over 8,000 members and, from 1 October 2010, becomes the Chartered Institute of Internal Auditors (IIA). It is the only professional body dedicated exclusively to training, supporting and representing internal auditors in the UK and Ireland. We are part of a global network of 170,000 members in 160 countries.

8. Members of the IIA work in all sectors of the economy: private business (including most FTSE 100 organisations), government departments, utilities, voluntary sector organisations, local authorities, and public service organisations such as the National Health Service. All members globally work to the same *International Standards* and *Code of Ethics*, which are part of a globally agreed *International Professional Practices Framework* and have been recognised in the Financial Reporting Council's Guidance for Audit Committees and adopted in UK central government's Government Internal Audit Standards and in the internal audit standards for the NHS.

9. The IIA offers a postgraduate level professional qualification in two stages, leading initially to the PIIA (practitioner) designation and subsequently to the designation "CMIIA" (Chartered Internal Auditor), with an ongoing requirement for professional development and adherence to professional standards. The qualification assesses a combination of knowledge, understanding and professional competence.

What is internal audit?

10. All organisations face risks in everything they do. It is the role of senior management and the board to put in place frameworks and processes to manage all types of risks and to monitor how successful they are at managing them. Internal audit provides assurance to the board on the effectiveness of these frameworks and processes.

11. To perform their role effectively, internal auditors must build strong relationships with line managers, audit committee chairs, chief executives and chairmen. These relationships enable the internal auditor to champion effective risk management, challenge those responsible for it on its success and use their knowledge of the business and the management of risk to act as a catalyst for improvement in an organisation's risk management practices.

12. Internal audit is a function that belongs to the organisation and sits within the governance structure; but it must be independent of the areas it evaluates and internal auditors must be free from undue influence from management, or indeed, anyone else, so that their judgments can be as objective as possible. To help safeguard their objectivity and independence, the head of internal audit should report directly to the audit committee

13. Internal audit is essential to the long term success of an organisation. This is because, alongside non executive directors, executive management and external audit, internal

audit is one of the four cornerstones of good corporate governance. Without it, the board would lack information and insight into how well the people within the organisation are managing their risks.

Three lines of defence

14. The three lines of defence model has been increasingly applied to corporate governance, and particularly risk management, over recent years. The IIA finds it useful to help demonstrate the different roles in governance and the interplay between them.

15. The IIA believes that risk management is an essential part of management. The first line of defence is formed by line managers who own the risks that they take every day.

16. In larger organisations, there are specialist "risk management functions" which support the line managers with this work. They form the second line of defence. They facilitate risk management activities, advise line managers and help ensure consistency of definitions and measurement of risk.

17. Internal audit provides the third line of defence. It is part of the governance process but sits outside of the risk management process. Internal audit regularly evaluates the effectiveness of each element of the risk management process and of the process overall, i.e. the performance of the first and second lines of defence. Internal audit may (and indeed should) use the outputs of risk management activity in forming its conclusions.

Internal audit compared to external audit

18. The IIA recognises that the historical connections between providers of external and internal audit services mean that many stakeholders may not be as familiar with the differences between external and internal audit as we are. The table below provides an outline of these differences. More detailed explanations of these differences are given in **Appendix 1.**

Table illustrating differences between internal and external audit

Item	External audit	Internal audit
Recipient of reports	Shareholders or Members	Board members and senior managers
Objective(s)	Add credibility and reliability to reports from the organisation to its shareholders by giving an opinion on them	Provide the assurance that members of the board and senior management use to fulfil their duties
Coverage	Financial reports and related disclosures, financial reporting risks and their management[16]	All categories of risks, their management[17] including the flow of information around the company, and governance
Timing and frequency	Project(s) tied into financial reporting cycle, focused on objective of audit opinion	Ongoing and pervasive
Focus	Mainly historical	Ideally forward-looking
Responsibility for improvement	None – duty to report problems	Fundamental to the purpose of internal auditing
Status and authority	Statutory and regulatory framework	International professional standards and Code of Corporate Governance
Independence	Professional ethical standards overseen by audit committee and regulatory framework	Professional ethical standards overseen by audit committee

[16] NB risk management starts with objectives/purpose, then includes identification, evaluation and assessment of the risk; selection and implementation of the appropriate responses; and monitoring to ensure that the responses are working as required.
[17] See footnote 1

Responses to questions relating particularly to internal auditing

Question 12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

Role of internal auditors

19. We have outlined above the role of the internal auditing profession. The IIA does not believe that role needs enhancing. However, we do believe that the corporate governance code for listed companies needs to recognise the modern role of internal auditing.

20. Currently, the Code of Corporate Governance of the Financial Reporting Council recognises the need for internal audit but treats it very differently from every other element that contributes to good governance, in that it requires companies only to consider the need for internal audit. We believe that the Code should be amended to include a clear provision that the company should have a professional internal audit function. This is particularly important for internal audit since it is not a statutory requirement. As with all other provisions, the company will be able to explain why it does not comply if it does not believe it needs internal audit (ie comply or explain).

21. Since modern internal auditing's scope is very broad and is intimately related to the information that the board needs, we propose that this provision be included within the Section B.5. of the Code, relating to the Information needs of the board.

22. In contrast, the requirements in the public sector are much clearer. The Code of Good Practice for Corporate Governance in central government departments and similar guidance for local authorities are clear that "the board should ensure that effective arrangements are in place to provide assurance on risk management, governance and internal control. In this respect, the board should be independently advised by: … an internal audit service operating in accordance with Government Internal Audit Standards."[18]

Interaction with external auditors

23. The IIA's *International Standards* impose on the head of internal audit a professional obligation to coordinate the internal audit activity with other assurance providers. We recognise that the work of the different assurance providers, including external audit and internal audit, may sometimes be looking at the same things in the same areas. Where that is the case, then a close working relationship, sharing plans and reports, can ensure that the organisation receives more effective and efficient coverage of all its risks.

24. However, it is important that the head of internal audit and the external audit partner work together in an environment where they both understand each other's objectives and scope and respect their different professional standards.

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[18] *Corporate governance in central government departments: Code of good practice July 2005*, available on HM Treasury's website.

25. In particular, it is essential that everyone involved, including external audit, internal audit, audit committees and regulators, recognises that, even when internal audit is working in the same areas as external audit, they are very likely to be addressing different sets of questions. These may not be appropriate to the needs of external audit and external audit will report that it is not able to rely on internal audit work to reach their conclusion on the truth and fairness of the

26. financial statements. This does not mean that the internal audit work is of poor quality or that there is unnecessary duplication. The audit committee may find that it benefits from receiving the different insights from the two groups of auditors.

27. There are two other areas of contemporary debate: firstly, the extent to which an accounting firm might provide its external audit client with internal auditors and, secondly, the extent to which an external auditor might use internal auditors to gather evidence to support the external audit opinion.

28. The IIA believes that internal audit and external audit are two of the cornerstones of healthy governance. If two of those cornerstones are provided by the same entity, it is likely that the entire corporate governance structure will be weakened. Therefore, we recommend strongly that an accounting firm does not provide internal audit services to its external audit clients.

29. The IIA believes that where the external auditor undertakes internal audit work there are – or there could appear to be – potential threats to the quality of external audit work from self-interest, self-reliance and taking a management role. In addition, the IIA believes that relying on the external auditor to provide internal audit services may pose threats to the independence, objectivity, competency and resourcing of internal audit services.

30. In the case of external auditors using internal auditors to gather evidence for their opinion, the IIA sees similar issues – it weakens the overall quality of governance. In addition, it may reduce the quality of internal auditing in the organisation since the opportunity cost of internal auditing completing external audit's work is less internal auditing resource to deploy on all the other risks facing the organisation. It provides a management problem for the organisation too. The internal auditors concerned may wish to obtain written confirmation from the organisation that their employer is happy to waive any terms related to confidentiality, etc, so that they can report findings to the external auditor.

Question 13. Should the role of audit committees be enhanced?

31. Audit committees already have a pivotal role in overseeing the audit arrangements of the organisation.

32. The IIA believes that the Code of Corporate Governance and the supporting Guidance for Audit Committees, provided by the FRC, concentrate too much on the financial statements and the external auditors. We would like to see some clarification and rationalisation which ensures that the audit committee satisfies itself in relation to competency, confidentiality, independence, objectivity, security of

resources of internal audit and of the effectiveness of the relationship between internal audit and the audit committee. We would like to see audit committee members:

a Understand the different objectives and scopes of external audit and internal audit.

b Support the external auditor in providing an effective service to the shareholders.

c Consider whether the non-audit services the external auditor provides undermine – or may be seen to undermine – the quality of the external audit

d Recognise the importance of the audit committee's role in providing the environment in which a healthy internal audit activity can flourish – the audit committee is key to self-regulation.

e Ensure that the activities of these two important services are coordinated and do not duplicate unnecessarily. However, the Institute advises audit committee members to bear in mind the value of both covering the operational risks of each business area and collecting evidence to support assertions in the financial statements – this may necessitate some overlap to provide effective checks and balances and healthy debate.

f Insist on the services of a competent, qualified and experienced head of internal audit to oversee all internal audit activity, including that carried out by any external service provider, whether a firm or individual contractors.

g Take care to provide effective support to the head of internal audit: build a relationship that allows the head of internal audit to challenge and to raise issues directly with the audit committee, unmediated by management.

h Take steps to ensure the competency of every person undertaking internal audit work.

i Ensure that anyone undertaking internal audit work is required – either by employment contract or by contract for services – to respect the international ethical and practising standards of the internal audit profession, as set out by the international Institute of Internal Auditors Inc and the IIA in the UK and Ireland.

j In particular, satisfy itself that all internal auditors:

   i respect the confidentiality of information about or from the company

   ii feel able to remain unbiased whether they are employees of that or another organisation

Question 14. Is the auditing profession well placed to promote improvement in corporate governance?

33. External audit has a key role to play in corporate governance. It gives a view on the reliability of the statements that are the tool to provide transparency over financial results, allowing the directors of a company to report to the owners. It wields a fairly blunt instrument: it can give a clean opinion or it can provide a less than clean opinion, all flavours of which can be disastrous to most companies. There is perhaps a limited role that the company's external auditor can play in improving these aspects of corporate governance.

34. Internal audit operates within the governance structure. Its role is both to provide assurance on the effectiveness of governance processes, including the management of risk, and to help the organisation to improve. When it is effective, it may not be very visible since it works to facilitate and assist the managers in making changes and improvements that they want to make. However, this way of facilitating change can be very effective.

Question 10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

35. Yes. We endorse the view of the external audit standards, which are clear that non-audit work poses potential threats to external audit quality. They identify six types of threats: self-interest, self-review, management, advocacy, familiarity or trust and intimidation.[19]

36. The external audit ethical standards provide extensive procedures that external auditors must follow to prevent such threats from affecting the external auditor's independence. The extensive inspection regime seeks to ensure that the standards are followed and, thus, mitigate the threats.

37. The only way to avoid threats arising would be to prevent audit firms from performing any other work. This would require a substantial reengineering of the industry and would have implications for the quality of the people involved and the work that they do and the price of audits.

38. For internal audit, the question is slightly different. Helping the organisation to improve is central to the internal audit role. However, the *International Standards* make it clear that internal auditors must not take management's responsibility when they do "consulting" work and that they may not provide assurance on those areas of the business where they have undertaken design work – thus avoiding the management and self-review threats above. In general, for internal auditors, "consulting" means facilitating the efforts of managers to make the changes they want to make.

[19] Para. 32 in Ethical Standard 1 (revised April 2008), issued by the Auditing Practices Board. See Appendix 2 for definitions of the threats.

Responses to questions relating to external audit that have implications for internal audit

Question 1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

39. There is a great deal of evidence available on this topic since it has been the subject of academic research and of the 2006 study[20] commissioned by the government. Our comments are limited to the relevance and implications for internal auditing.

40. Internal auditing is essentially different from external audit. The market for internal audit services in the private sector is smaller than that for external audit services in that it is not mandated in most of the sector. In addition, in-house teams still meet much of the demand for internal auditing, particularly at the larger end of the FTSE index, where concentration for external audit services is more of a concern. This reduces still further the market for internal audit services supplied by third-party contractors.

41. The demand for internal audit services from third-party contractors comes from two sources. Firstly, in-house heads of internal audit do often supplement employed resources with extra

42. resources either to fulfil a spike in demand or to meet a need for specialist skills, eg in computer auditing, a practice often described as co-sourcing. Secondly, some organisations out-source their whole internal audit department.

43. The supply of internal auditing services is met not only by the big four global firms but also by small specialist consultancies, independent contractors, the mid-tier and smaller accounting firms and two large international consultancies, Jefferson Wells and Protiviti, which are not accounting firms.

44. We have recently commented to the Auditing Practices Board on their call for evidence with regard to the rules that guide external audit firms in providing non-audit services to their external audit clients. As outlined above in the answer to Question 1, we strongly believe that it is healthier for corporate governance if the statutory auditor of an organisation does NOT provide internal audit services to that organisation. We would like to see the rules strengthened in this area to prevent that aspect of concentration.

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[20] Report entitled *Competition and choice in the UK audit market* prepared by Oxera for Department of Trade and Industry and Financial Reporting Council, April 2006

Question 2. Does a lack of competition mean clients are charged excessive fees?

Question 3. Does a narrow field of competition affect objectivity of advice provided?

Question 4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

45. The research referred to above did find some relationship between the increase in audit fees over 25 years or so and the increasing concentration of the market for external auditors. However, they also point out that there are other drivers including the increasing complexity of external audit and the desire of audit committee chairs for quality.

46. We support the need for a quality external audit product. At present, the "client" is often in practice the executive management of the organisation who perhaps benefits least from the external audit. We support any practical development that gives a bigger say to the shareholders, and other owners, in appointing and retaining an external auditor.

Question 5. What is the role of auditors and should it be changed?

47. Above we have outlined the role of external auditors and the role of internal auditors. The IIA does not see the need to change these roles but would like to see better understanding of the similarities and differences. This needs regulators such as the Financial Services Authority (FSA) and FRC and bodies such as the CBI and the Institute of Directors to recognise and promote the role and value of internal auditing.

Question 6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

48. The debate about scepticism raises interesting questions for both internal and external auditors. The evidence we have gathered so far does not support a lack of scepticism from internal auditors in the banks in the run up to the 2008 financial crisis. However, the question remains: how can internal audit help to prevent a future crisis? The IIA is shortly to undertake a review that will seek to provide answers to that question. It is unlikely that the results of this work will be available in time for the committee's report.

49. It is possible that it was not scepticism that was missing but the capacity to think differently from everyone else in society – not just in the companies being audited. Even if the external auditors had had that capacity, how capable would the other

players in the market have been to hear what they said – not just executive management but also non-executive directors, investors, shareholders, regulators, media and even policy makers?

50. This has implications also for internal auditors. Although they are independent of the parts of the organisation on which they give assurance, they are still part of the organisation as a whole. They need to make efforts to cultivate a different perspective from the rest of the organisation. The IIA provides educational and networking opportunities, allowing internal auditors to mix with colleagues from different sectors and industries. This helps them to develop new perspectives and supports them in presenting the challenges to management that may result from such scepticism.

Question 7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

Question 8. How much information should bank auditors share with the supervisory authorities and vice versa?

51. In responding to the FSA last year on the conclusions of the "Turner Review", the IIA stated that the FSA ought to be able to rely more on the work of internal auditors. A very large proportion of the risks in which the FSA is interested are also of interest to their supervised firms. Therefore, they should be the risks that are within the scope of internal audit in those firms. There is scope for the FSA, or any new regulator, to obtain assurance from the existing work of these internal auditors.

52. However, we also pointed out that this must be done sensitively. As long as internal audit is a function that is operationally independent, it delivers real value to management because it enhances the organisation's ability to achieve its business goals. We have discussed above one aspect of internal audit's independence: being separate from the functions it evaluates. However; interaction with the regulator could pose a different threat to independence: internal audit being perceived as an extension of the regulator, rather than focussing on the needs of the business.

53. Therefore, any move to provide more information to the regulators than is already done must safeguard independence in order to protect the overall quality of the work on which the regulator is relying. One way to achieve this would be to encourage the management of financial services organisations to refer, in their reports to the regulator, to the evidence they have to support their assertions. This would include the results of internal audit work performed by competent, qualified internal auditors working to internationally recognised professional standards.

Question 9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

54. For internal auditors, the best incentive to provide such advice is the response of those receiving it. High quality internal auditing does not exist in a vacuum: it needs openness and receptiveness in the management team. One mark of effective heads of

internal audit is that they have raised with senior managers issues and facts that were unwelcome. Audit committees can help here by insisting that performance assessments of heads of internal audit are realistic, ie that they recognise that such uncomfortable conversations are a sign of good performance. The IIA also seeks to help by preparing internal auditors to work in this environment and by providing them with networking opportunities to help them deal with the resultant stresses and strains.

Question 11. Should more competition be introduced into auditing? If so, how?

55. See response to question 12 above re: internal auditing.

Appendix 1
Key Differences between internal and external audit

Main "customers" of the assurance

1. External auditors provide assurance to the shareholders or members of company, ie outside the company's governance boundary. It is vital to the quality of their work that they focus on this customer group.

2. Internal auditors, in contrast, provide assurance within the governance boundary, to the audit committee, the board in general and to senior management.

Purpose of the assurance

3. The external audit opinion, and the work that the external auditor performs in order to provide it, exist to add credibility and reliability to reports from the company to its shareholders.

4. Internal auditors provide members of the board and senior management with assurance that they can use to fulfil their own duties to the company and its shareholders.

Coverage or nature of work

5. External audit provides an opinion on financial statements and the related disclosures, on other forms of reporting from the company to shareholders as well as on financial reporting risks and their management.

6. Internal auditors cover all categories of risks and their management, starting from their identification, taking in various responses to risks, including traditional internal controls, and including the flow of information around the company about risk. Internal auditors also cover governance processes.

Timing and frequency of audit work

7. Ideally, internal auditing is a permanent and ongoing presence in a company. Much of its work will be in the form of engagements scheduled in advance. However, internal audit may also react to changes in circumstances and undertake unscheduled and, possibly, surprise pieces of work.

8. External audit work is tied into the company's cycle for financial reporting and designed to support the external auditor's opinion on the annual report and related items.

Focus of opinion

9. The external audit focus is predominantly on validating that the financial statements are a true and fair representation of past performance.

10. For internal audit, the focus ideally is on providing assurance that the governance and risk management processes are effective in managing risks that might happen. Therefore, the focus is also forward-looking.

Appendix 1 (continued)

Responsibility for improvement

11. External auditors have no explicit responsibility to improve their clients' governance or risk management processes. They have a duty to report problems that they come across as part of their work. In addition, the added-value service proposition of audit firms as businesses means that they want to assist their clients where they can.

12. In contrast, improvement is fundamental to the role of internal auditing. Working within the organisation on an ongoing basis allows internal auditors to advise, coach and facilitate managers' efforts to improve processes. At the same time, internal auditors have a professional duty to avoid usurping the responsibility of those managers to manage.

Status and authority

13. As a regulated profession, external audit's status and authority is provided by statute and supported by the framework of regulation provided by the FRC working with the appropriate professional bodies.

14. Internal auditing has a set of professional standards, the *International Professional Practices Framework*, including a *Code of Ethics*[21] and the *International Standards for the Professional Practice of Internal Auditing (International Standards*) [22]. These require the head of internal audit to establish an internal audit charter that sets out the authority of the function and to present this to the audit committee and senior management. Internal auditors rely on the support of the audit committee to maintain their status and authority.

15. The UK Code of Corporate Governance provided by the FRC recognises that the audit committee is responsible for overseeing the effectiveness of internal audit. The Guidance for Audit Committees, also provided by the FRC, provides additional tasks and recognises the *International Standards* as a source of more detailed guidance.

Independence

16. A reflex reaction is often that external audit is more independent than internal audit. To counter that, there is also a view that no-one who engages with an organisation or person is entirely independent of them.

17. For internal auditors, independence is about avoiding responsibilities for functions on which they provide assurance and having a reporting line to the audit committee that provides some degree of guarantee of their independence from the areas they evaluate. It is also necessary to be sure that internal auditors are independent of any other group, such as other assurance providers or regulators, in order to ensure that the assurance they can give is also independent.

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[22] © 2008 idem

18. For the external auditor, the profession's ethical standards and other regulations and rules seek to protect independence. There is an extensive regulatory regime in place, administered by the accounting bodies and the FRC, that enforces these standards. In addition, the UK Code of Corporate Governance expects the company's audit committee to review and monitor the independence and objectivity of the external auditor.

Appendix 2

Threats to external audit quality – as summarised in answer to question 10 above

A self-interest threat – when the external auditor has financial or other interests which might cause it to be reluctant to take actions that would be adverse to the interests of the audit firm.
A self-review threat – when in the course of the audit, the external auditor may need t o re-evaluate the work performed in the non-audit service.
A management threat – when partners and employees of the audit firm from take decisions on behalf of the management of the audited entity and the audit firm may become closely aligned with the views and interests of management.
An advocacy threat – when the audit firm undertakes work that involves acting as an advocate for an audited entity, supporting a position taken by management in an adversarial context and adopting a position closely aligned to that of management.
A familiarity (or trust) threat – when the (external) auditor is predisposed to accept or is insufficiently questioning of the audited entity's point of view (for example, where close personal relationships are developed with the audited entity's personnel through long association with the audited entity).
An intimidation threat – when the (external) auditor's conduct is influenced by fear or threats (for example, where the auditor encounters an aggressive and dominating individual).

Memorandum by KPMG LLP

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1. ***Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?***

1.1 Independent reports from Oxera and London Economics to the UK Government and regulators and the European Commission underlined that the drivers to concentration were greater capacity/international coverage to serve global/complex organisations; technological innovation; need for industry knowledge/expertise to serve clients, reputation and liability risk. Concentration was exacerbated by the regulatory response to the problems of Arthur Andersen which led to its collapse.

1.2 The market pressures continue today. The world's major companies continue to expand both through organic growth and consolidation demanding an ever increasing international

audit capability. At the same time diverse national regulatory requirements continue to increase - including registration, annual returns, inspection, disclosure and ethical standards. This means significant investment in processes, infrastructure, expertise and technology but most importantly in people who are essential to quality. These factors create economies of scale which do help firms to expand and drive a virtuous circle with the best people joining those firms that are successful, reinforcing that success thereby attracting the best people.

2. ***Does a lack of competition mean clients are charged excessive fees?***

2.1 No. Cost is an important factor in the consideration of the appointment of auditors. A KPMG survey of Audit Committee Chairs puts cost as the fifth highest factor in the appointment of auditors behind issues like auditor communications, robustness and perceptiveness. In our experience when audits are put out to tender there is fierce competition, including on price, across all sizes of company. Even for those companies which do not go out to tender the audit fees are often benchmarked and in our view an appropriate balance is normally struck between cost and quality.

3. Does a narrow field of competition affect objectivity of advice provided?

3.1 No, we haven't seen any evidence that suggests that audit quality has declined since the consolidation to fewer large firms. Quality of opinion is paramount to the reputation of audit firms. This is backed up by rigorous training, strong ethics and enhanced by the multi-disciplinary nature of the UK profession.

3.2 The Snyder-Myners Report, *Professional Services Global Competitiveness Group* in 2009 recognised the world leading position of the UK profession, "The UK accountancy profession is well respected and influential internationally. The resilience and strength of the UK multi-disciplinary model and the emphasis on judgement and principles are internationally recognised."

4. ***Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?***

4.1 No. Although it is possible that this may have happened, we have not seen any evidence that supports this argument. In our view the more important factors have been the profound and welcome changes to the profession in recent years – independent oversight, public reporting, the role of audit committees and the introduction of a code of governance for the major audit firms. These have all enhanced the independence of auditors and underpinned improvements in audit quality.

5. ***What is the role of auditors and should it be changed?***

5.1 The auditor is currently responsible for auditing the financial statements – prepared by management – to provide reasonable assurance to the investors that they are fairly stated in all material respects. The financial crisis has challenged all the key players in the global capital markets to re-examine their roles and effectiveness and the business reporting and the assurance framework should be part of this re-examination.

5.2 We believe however that it is essential to retain the existing division of responsibilities – the company reports and the auditor provides assurances on those reports. Within that framework KPMG is keen to engage in the debate and find solutions that carry broad support. This might include expanding both the nature of assurance reporting and extending its scope beyond the financial statements and even perhaps beyond the annual report to other forms of corporate reporting. There might, for example, be some form of risk reporting for which auditors may not be the exclusive provider of assurance.We have also made suggestions as regards reporting to financial institution regulators in our response to the recent consultation paper from the FSA and FRC, we set out some of these ideas in our answers to question 7.

6. ***Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributing factor?***

6.1 In our experience auditors were sufficiently sceptical in the run-up to the financial crisis. We disagree with recent assertions to the contrary by some in the UK regulatory community. Such assertions of a lack of scepticism do not accord our engagement with regulators at the time. In any event, even if our view on professional scepticism was to be challenged we see no obvious connection with concentration.

6.2 As the House of Lords Select Committee on Economic Affairs Report said in June 2009 “We have no evidence that bank auditors failed in their statutory duty to make going concern judgement on their clients. Bank auditors should not be required to make a more general judgement on the quality of their clients’ strategies.”

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

7.1 In our view whilst the auditors can contribute to an improved regulatory and micro-prudential regime, they could not themselves have “mitigated” the banking crisis. Banking as an industry is heavily impacted by the general economic environment and asset prices in particular. This environment is shaped primarily by politicians, policy makers and central banks across the world. The need for change in this area is also recognised. As the Governor of the Bank of England said recently “We let it slip...the crisis was caused not by problems in the real economy; it came out of the financial sector."We welcome the new focus in the UK on financial stability and better macro and micro prudential supervision - as auditors we stand ready to play our part in that.

7.2 In the UK we support a new transparent and coherent process with a clear set of principles for a good working relationship between regulators, financial institutions and auditors. KPMG welcomes the debate that has been started by the FSA and the FRC on this and the parallel dialogue with the Bank of England. We have discussed in our response to the recent FSA and FRC consultation paper how a framework of dialogue between those charged with governance, auditors and regulators might work. The table below summarises our proposals.

Meeting	Objective	Attendees	Timing

Type			
Micro prudential	Covering culture, risk appetite, business model, what can go wrong, key judgements and decisions, effect of macro prudential issues	Tri-lateral: Regulators, Audit Committee and Auditors	Semi-annual
Micro prudential	"Safety valve" meeting between auditor and regulator	Bi-lateral: Regulators and Auditors	Annual or as required
Micro prudential	Discussion of key accounting judgements and disclosure	Tri-lateral: Regulators, Audit Committee and Auditors	Pre-issuance of financial statements – could be expanded to half year/quarterly reports
Micro prudential	Cross border regulator issues	Tri-lateral: Relevant Regulators, Audit Committee and Auditors	Annual
Macro prudential	FSA and auditors market issues – may require hot topic sub groups to continue discussions	Large audit firms and regulators	Quarterly
Macro prudential	Financial Stability Board/G20 agenda	Large audit firms and regulators	Semi Annual
Supervisory	Performance of audit firm (see comments on monitoring arrangements below)	Audit firm, FRC and FSA	Annual

8. How much information should bank auditors share with the supervisory authorities and vice versa?

8.1 We do not believe that there should be any significant limitations on the client information that could be shared between regulators and auditors and financial institutions as part of the trilateral process that we advocate.

8.2 The difficulty is in filtering and identifying the key issues from such a volume of information. This requires a structured reporting framework and communication

mechanism setting out what information is required, when and in what format. This whole area might benefit from a code of conduct or a set of protocols which formally recognises the respective roles and responsibilities of all the different parties.

9. ***If need be how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?***

9.1 We believe the incentives are already very strong. It is critical to the reputation and hence success of the audit firms that they provide objective advice, which in some cases will be unwelcome to clients. This is supported by clear ethical and professional standards and is an area on which the FRC already has a clear focus with their central objective of market confidence in high quality financial reporting and corporate governance.

9.2 Audit committees also play a key role in this dialogue and we have commented on their role further below.

10. ***Do conflicts of interest arise between audit and consultancy roles? If so how should they be avoided or mitigated?***

10.1 In our view the issue is more one of perception than reality. We fully accept however that it is important to deal with this perception, but we believe this is best achieved through the triple lock of strong corporate governance; a clear Code of Ethics and the threats and safeguards approach. In addition, the recent agreement to a Code of Governance by the larger UK audit firms and the appointment of independent non-executive directors will further reinforce the public interest nature of the profession. The APB has been looking at reforms of non-audit services and in July 2010 published the results of consultation and reported that the "overwhelming view" was that there should be no outright prohibition of non-audit services but further consultation on stronger guidance to audit committees; extension of the threats and safeguards approach and a specific look at a small number of service areas like restructuring advice. KPMG support this approach whilst agreeing with the view of the Synder-Myners Report that "strong provision of other services like tax advice is critical to the competitiveness of the corporate sector."

11. ***Should more competition be introduced into auditing? If so, how?***

11.1 Our Joint European Chairman John Griffith-Jones wrote in the FT 15th September 2006, "We agree that in an ideal world there would be more than four 'big' audit firms. Greater realistic choice for companies can only be a good thing….the solution lies in the creation of a successful fifth firm not the destruction of the existing four."

11.2 In the UK the FRC – through a Market Participants Group reporting in 2007 set out 15 recommendations to increase choice in the audit market whilst maintaining quality and independence eg a code on corporate governance for larger firms and guidance to audit committees re use of larger firms. In Europe, Commissioner McCreevy studied a variety of reforms and recommended in 2008 that there should be liability reform across the EU to improve choice and competition. These approaches which "encourage" rather than "require" and consider, for example, cost/benefit and regulatory burden are consistent with the emphasis of the new UK Coalition Government.

12. ***Should the role of internal auditors be enhanced and how should they interact with external auditors?***

12.1 The internal auditor is only one, albeit important, way in which the directors and management control a company. The range of companies and their activities is in our view too great to set any general mandatory internal audit requirements. In addition, within the regulated financial sector the FSA already review whether the level of internal audit within individual institutions is appropriate.

12.2 As regards the relationship between internal and external auditors this is governed by the International Standards on Auditing which in our view strike an appropriate balance between the desire to prevent unnecessary duplication (and hence inefficiency) with the need for the external auditor not to rely unduly on a function which is by definition not independent. These arrangements are subject to both company review (Audit Committees) and regulator oversight (AIU inspections and APB review).

13. ***Should the role of audit committees be enhanced?***

13.1 In the UK Audit Committees have a powerful role and we have not identified any areas which need enhancing. The UK Corporate Governance Code (which defines the role of the audit committee) and the associated FRC Guidance for audit committees is kept under regular review by the FRC and already goes well beyond the recent requirements introduced by the EC Statutory Audit Directive. It was last updated in 2008 in response to MPG recommendations to require disclosure of how the audit committee reached its recommendation re the appointment of the auditor (including information on tender frequency, tenure of the incumbent auditor and any contractual obligations that restrict the audit committee's choice).

13.2 However, it is key that investors in particular have confidence in the those appointed as their agents and we remain open minded as to how this might be enhanced for example through being more involved in the selection of non-executives.

14. Is the auditing profession well placed to promote improvement in corporate governance?

14.1 In our opinion the knowledge gained during an audit and the experience auditors have through auditing many businesses ensures they are well placed to promote good corporate governance (both in the round and for their audit clients). EU Directives (and International Auditing Standards) require external auditors to report to the audit committee (or others charged with governance) on key matters identified during the audit including deficiencies/weaknesses in internal control.

14.2 Audit firms have taken the lead in promulgating good governance practice. For example, long-before Sir David Walker's recommendations stressed the importance of training and development for non-executive directors, KPMG set up the Audit Committee Institute (now operating in 30 countries) to provide complimentary guidance and a variety of resources designed to assist audit committee members (and other non-executive directors) update and refresh the skills and knowledge which are essential to their role. This is a serious commitment with around 50 seminars, workshops and other colloquium provided each year in the UK.

28 September 2010

Memorandum by Mr Stephen Kingsley

This note offers views on some of the issues raised in the Call for Evidence published by the Select Committee.

1.1 A little background. Four firms currently dominate the auditing business globally and, between them, would appear to have over 250,000 employees dedicated more or less exclusively to audit and assurance, generating approximately $46 billion in fees. These figures are based on data drawn from the firms' websites. Auditing is a thus big and costly business. Unquestionably, stakeholders in the corporate sector, whether investors, lenders, employees, tax authorities or regulators, need to be able to rely on the financial information that they receive. So, when analysts and others look at financial information provided by corporates, they need to believe that what they are looking at is complete, accurate and fairly presented. The notion that an outside expert has examined this information with these criteria in mind ought to give them the comfort which they seek. The question is – does it? Put another way – we all want to see truth and fairness in corporate reporting, but is external auditing an effective way to achieve this objective? Just as importantly, even if external assurance is thought to be a good thing, is a legally-mandated rules-based system operated by what is essentially an oligopoly of four global firms the best way of delivering it?

2.1 What is the purpose of auditing? Statutory auditing seems to have become formalised in early English company legislation which, by creating joint stock companies, recognised the separation of management and ownership of businesses, and allowed external capital to be provided by people who would have no direct line of sight to the business that they were funding. To compensate for this, the concept of the mandatory statutory audit emerged as way of providing assurance to shareholders as to the truth and fairness of management's account of the way in which their money had been put to use. This concept has been developed over the years so that we now have reports and accounts, accounting principles, and a persistent attempt to create some global consistency in the way companies account and report on their operations so as to mirror the globalisation of the market for corporate capital. The statutory auditor has played a key role in this process and, almost everywhere, is a mandatory element in the corporate reporting process.

2.2 Indeed, their role and responsibility has been widened as the reach of regulation has itself widened. For instance, financial institutions have detailed regulatory reporting responsibilities which often require the intervention of external auditors. Furthermore, the supervisors often rely on external auditors to perform inspections.

2.3 There are, or arguably should be, stakeholders in the audit process other than shareholders and regulators. A case could be made for the formal stakeholder group to include lenders, creditors, employees and the tax authorities.

3.1 Does auditing meet these needs? Does the status quo drive companies and their auditors to do the right things? External auditing involves the transfer of responsibility for the accuracy and completeness of financial information from management to an independent expert. But the transfer is not complete, as a quick scan of a typical audit report will confirm. The extent to which responsibility is transferred and, therefore, the extent of auditor liability for errors and omissions, is a grey area. From time to time, this gets to be tested in the courts. Most often, however, it is settled behind closed doors – which means that the uncertainty persists. There is also uncertainty about who is entitled to rely on information signed off by statutory auditors. The result is confusing – both for the audit firms and for stakeholders.

3.2 As accounting and reporting rules have proliferated, compliance with these requirements has become both technical and challenging. Managements understandably consult with the auditors on such matters since they are the experts. Equally, it should be understood that this is accounting and not auditing – and there is a big difference. Two problems arise. First, there a clear potential for conflict here since the auditor now 'owns' the answer rather than checking it. Secondly, the burden of compliance with these requirements is such that the balance between ensuring compliance and 'real' auditing is now likely to be wrong.

3.3 Where management has put together a comprehensive and accurate set of financial information and where "there is nothing to hide", external auditing is relatively straightforward and is unlikely to add a much value External auditors are really needed when management does have something to hide, and where the truth has either been massaged or masked. Unfortunately, auditors are near-defenceless where management is intent on deceit and is sufficiently competent to cover its tracks.. Indeed, the extensive caveats in their contracts and their reports tend to support this.

3.4 Management may feel that the auditor can and should be blamed when accounting and reporting issues surface. We should remember that it is management's responsibility to prepare financial information - as audit reports make very clear – so management really needs to be fixed with the responsibility of any material errors, particularly if these are deliberate. The very existence of the external auditor helps to blur responsibility for external reporting.

3.5 Corporate accidents **-** frauds and insolvencies – often result in assertions that the audit 'went wrong', and thus lead to action against the auditors, mainly because they have deep pockets. When this happens, audit firms act as de facto insurance companies and yet, ex ante, do not operate like insurers. If they did, they would likely be much more differentiated about the audits that they did, the scope of their work, and what they charged.

3.6 The result of all of this is the so-called 'expectation gap'. This is the difference between what auditors think they do and what outsiders think auditing means –and the debate about it has been going on for at least the last four decades. If anything, the gap has increased over that time.

4.1 Perhaps the concept of auditing is flawed and should be debated? Some of the preceding arguments might suggest that the concept of auditing is inherently flawed and that the perhaps 150 year-old experiment with statutory auditing should be closely

examined. Why has this debate not taken place, despite the unsatisfactory status quo? External auditing provides a valuable "tick in the box" for all kinds of users – analysts, rating agencies, shareholders, bankers, trade creditors and tax authorities to name but a few. Changing what has become a globally accepted regime would require agreement from the key jurisdictions (US, EU, Japan) – and that is unlikely to happen any sooner than the emergence of a contender to challenge the domination of the Big Four. Instead, much of the debate around statutory auditing tries to deal with two different problems - the lack of competition to the Big Four and auditor liability. Whilst it might be interesting to introduce more firms into the global auditing game, I doubt that it would change the dynamics that I have described. In any case, given the enormous barriers to entry, introducing a new competitor would be a real challenge. As for auditor liability, lack of limitation clearly concentrates the mind and does not seem to, of itself, have led to the collapse of any major firm – including Arthur Andersen. At best, it seems to be a peripheral part of the problem.
4.2 Issues of competition. It is received wisdom that competition is a 'good thing'. It should ensure that customers get fair prices, high quality goods and services, and benefits from innovation. On the face of it, the market in statutory auditing of large corporates is a four-firm oligopoly. As a result, there is only one company in the FTSE100 which is not audited by the four firm group. Others can comment better than I on whether customers are damaged in consequence. It is clear, however, that it will be really difficult to widen market access. There seem to be a number of simple reasons for this:

1. Audits change hands very infrequently
2. Much of the selection process is in the hands of Big 4 alumni who, apart from anything else, are possibly loath to deal with what they see as an unknown quantity
3. An enforced break-up of the Big $ is likely to prove practically very challenging
4. The aspirant firms, of which there are perhaps one or two, have neither the experience, personnel or footprint to deal with many of the complex international companies.

4.3 It may therefore be more pragmatic to 'accept' the oligopoly and to introduce some new thinking into the way it operates.

What can be done to improve the status quo? Here are three ideas:
Idea #1

5.1 The culmination of an auditor's work is the audit report. Whilst audits may be a mandatory requirement for listed companies and regulated financial firms in most jurisdictions, the wording of the audit report is something which is largely left up to the profession. This, in my view, has a number of undesirable consequences:
a. The length and complexity of wording of the reports has increased
b. The reports contain somewhat arcane phrases like 'true and fair' (in the UK) and 'presents fairly' (in the US) the precise meaning of which is not clear to most readers and which has all too often had to be tested in the courts
c. It leads to 'box ticking'
d. The gap between what we all think auditors do and what they think they do is allowed to persist

5.2 It is worth focussing on this last point about reporting. The latest manifestation of the problem is in the report by Mr Valukas on the demise of Lehman. One easy step that could be taken to increase usefulness and close the expectations gap starts by recognising

that auditing is a public service and that what auditors say about their work is a matter of public interest. It should follow that users, via the relevant authorities, should state what they want auditors to say in their reports. What the reports could say about the accounts might include comments about:

1. Accuracy and completeness
2. Compliance with applicable accounting and reporting standards
3. Whether they 'make sense'

5.3 This last point is both new and key. Accounting and reporting standards have been, and will continue to be, arbitraged by exploiting loopholes or inconsistencies. Indeed, the larger the rulebooks, the likelier this is to happen. This is not to say that this happens all the time or that everyone does it, but it does happen. It can lead to accounts being technically compliant but nevertheless not making much sense in terms of reflecting reality. Insisting that auditors say whether or not the accounts make sense would lead to better balance between the application and application of judgement, and should serve to make their work much more useful.

5.4 As is inevitable with any system founded in statute, and in line with developments in other areas of society, external auditing has become increasingly based on rules rather than principles, reducing the need to apply judgement and experience, to the possible detriment of quality.

5.5 There is a further point here. Standards governing both accounting and reporting have, particularly over the last few years, become more and more complex. The process of standard setting, whilst not controlled by the large accounting firms, is certainly capable of being influenced by them. The increasing complexity seems to have led to a position where, for many companies, the accounts are becoming incomprehensible to most readers. Perhaps worse yet, some of the more recent developments in accounting standards are controversial and seem to have unintended consequences – fair value accounting comes easily to mind in this context. This suggests a rethink and perhaps a move back towards simplicity.

Idea #2

5.6 Accounting is, in some senses, the reconciliation between corporate imperative and economic reality. The auditor's role in this process is to ensure that this reconciliation is fair and follows the rules. Managements, quite understandably, sometimes get caught on the wrong side of this reconciliation and seek to take evasive action. Part of the answer may be to make more serious the consequences of being detected. There continues to be a significant blurring of the line between the respective responsibilities of management and auditor. It is normally the case that an auditor stands little or no chance in the face of management intent on deceit. If this position is accepted, then the response needs to be a more rigorous and unambiguous treatment of managements who deceive

Idea #3

5.7 There are some fundamental differences between auditing and everything else that the firms do. This is because auditing should not be about advice; it should exclusively be about an objective assessment of someone else's work. Moreover, the real client is not the enterprise being audited or its management; it is the external stakeholder group –

shareholders, creditors, regulators and so on. The audit committee is an attempt to enfranchise this group but is unlikely to do so effectively. In a very real sense, auditing is a public service and the organisations that deliver such a service need a culture which corresponds. The rest of what the firms do is, for the most part, not like this, and requires a different culture. Managing these two cultures within the same organisation is, in my view, a serious challenge and one which, if not handled properly, creates the risk of conflicts of interest. This in turn can dilute the healthy scepticism with which auditing should be conducted and the consequent willingness to deliver 'bad news'. This line of argument might point towards the mandating of 'audit only' firms.

The author

6.1 Stephen Kingsley worked in the financial services practice of Arthur Andersen for thirty years, latterly as head of the firm's global practice. He is currently a senior managing director in the London office of FTI Consulting, a global expert services firm. He is also a non-executive director of the Co-operative Financial Services Group. The views expressed herein are those of the author.

September 2010

Memorandum by Kingston Smith LLP

Following on from the House of Lords announcement on 27 July 2010 that you had decided to conduct an enquiry into auditors, specifically market concentration and their role, we are pleased to provide our response.

Although we have responded to the questions posed in the announcement in turn below, we wish to stress the following key points:

- The enquiry appears to follow on from the banking crisis and subsequent increasing focus on the auditing profession, including the Treasury Select Committee report on the crisis (The McFall Report);

- The Big Four firms, and indeed the profession as a whole, make a significant contribution to the UK's gross domestic product and therefore the Government should be encouraging such businesses and assisting them to grow for the benefit of the UK, rather than seeking to place further obstacles in their way;

- There is no evidence whatsoever of problems arising, either in the banking industry or elsewhere, as a result of issues caused by audits, or of any systemic issues with the way audits are conducted;

- There has been much institutional investor focus on what an audit should deliver and it is clear that there is an expectation gap which may arise from misperceptions of

what an audit is designed to do. However, it is not clear how that gap can be addressed without prohibitive costs (and other implications) for the profession and potentially for businesses;

- It must be stressed that the vast majority of UK companies are owner managed and do not therefore have institutional investors. The views of institutional investors should not therefore be prioritised over those of other stakeholders, particularly the companies themselves and their directors;

- The profession is already subject to stringent professional standards, not least the ICAEW Code of Ethics, and the Ethical Standards for Auditors, which already create some barriers to the provision of efficient client service in certain respects;

- The already high degree of regulation, together with misperceptions of the role of auditors, the lack of a workable liability limitation mechanism, and the risk of adverse public comment, acts as a barrier to increased competition for the audits of larger public interest entities. In particular, there is an urgent need to find a workable solution to allow auditors, and indeed other professions, to limit their liability in a meaningful and fair way, proportionately to the degree of fault so that auditors are not at risk of a ruinous action due to being perceived to have the deepest pockets. The threat of such an occurrence is very real particularly as the largest firms are unable to obtain adequate insurance cover.

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

In the first instance, it is not entirely correct to state that 'auditing' has become concentrated on four global firms. Whilst it is undoubtedly true that the audit of major listed entities, and particularly banks, has become concentrated on the Big Four, the audit of smaller listed companies, those traded on AIM and Plus, and particularly the audit of smaller owner managed businesses is much more evenly spread across the profession. Small companies often look to smaller audit firms for their professional advice as they believe such firms will better understand their needs; the same logic applies to entrepreneurial businesses which will look to firms that specialise in such businesses and are able to address their needs, including, where appropriate, pursuing flotation.

There are various reasons why the audit of major listed entities has become concentrated on the Big Four. Undoubtedly, the raft of mergers which has taken place in relatively recent times has aggravated the situation. A 'Big Eight' became a Big Six and then a Big Four within a relatively brief time frame following the merger of Price Waterhouse and Coopers and Lybrand, and the collapse of Andersen; indeed the situation could have been worse had the proposed merger in the late 90's of KPMG and Ernst and Young actually gone ahead.

Another issue is the reluctance of major listed entities to look outside the Big Four for their auditors. This may be due to (unjustified) perceptions of the capability of the mid tier to service such entities; in some cases, it may be due to restrictive covenants (for instance the availability of bank finance being dependent on having a Big Four auditor). There is perhaps a perception among major listed entities that having a Big Four auditor is the best guarantee of audit quality but this is a misperception. Mid tier firms have demonstrated themselves perfectly capable of auditing major listed entities, one obvious example being Partygaming which at one point was part of the FTSE 100 and which was (and still is) audited by BDO.

There are various other reasons why smaller firms do not compete in this market, particularly in respect of banking audits. Because banking audit is entirely concentrated among the Big Four, there has been no opportunity for mid tier firms to develop the necessary level of expertise; indeed it is difficult to see how such expertise could be developed unless, for instance, a banking audit team decided to move from a Big Four firm to a smaller firm en masse (and even in this case there is no guarantee that banking clients would follow). Indeed, the risks and costs of attempting to compete in this market would be likely to far outweigh the benefits.

This is less of an issue in other sectors, where the key issues affecting (say) a large haulage company preparing its accounts under IFRS may not be significantly different from those affecting a smaller one. There may be issues of headcount and logistics to overcome but these could potentially be dealt with. Experience can, however, only be obtained by undertaking the relevant work and it is disappointing that many larger public companies do not give smaller firms the chance to show what they are capable of.

However, at present we believe that a key issue is that mid tier firms may well consider that the risks of taking on major listed entity audit work outweigh the benefits of doing so. The risks of taking on this work are both financial – as noted in our introduction, the risk of a ruinous action being taken against the firm because it is perceived to have the deepest pockets - and reputational, given the degree of adverse public comment and misinformation there has been about auditors in the media in recent years.

The additional levels of regulation involved also act as a barrier and ultimately these factors combine to make the rewards of taking on such work simply not worth the risk. What is needed in order to increase competition in the audit market is for it to be made more attractive to mid tier firms, not less, and this requires government to ensure that the regulatory framework is streamlined rather than added to – and that a workable limitation of liability mechanism is incorporated in statute as a matter of urgency.

2. Does a lack of competition mean clients are charged excessive fees?

Again, this question appears to presume a lack of competition 'across the board' in the profession which is simply not the case.

In respect of major listed entities – and particularly banking entities – the fees charged by any practice will reflect the size and complexity of the entity and the regulatory environment in which it operates, as well as the specialist knowledge which the audit team will require. It is simply not possible to generalise by stating that the fees charged by a large firm would necessarily be excessive. Moreover, competition does exist within the Big Four, and the fee that one of the large firms may charge for a particular audit will not necessarily be the same as what one of the other firms would charge.

3. Does a narrow field of competition affect objectivity of advice provided?

There is no particular reason why a narrow field of competition would necessarily affect the objectivity of advice provided. The Ethical Standards for Auditors combined with the ICAEW code of ethics provide a robust framework of ethical standards and guidelines to ensure that auditor integrity is not compromised.

What is more likely as a result of a narrow field of competition is the existence of conflicts of interest. Again, there are mechanisms in the ethical framework for managing these, but the concentration does mean that issues are more likely to arise.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

It is not clear from this question what the Committee means by 'unwelcome advice'. There may be many situations where an auditor is required, as a result of maintaining their own professional standards, to give advice which may not be what the client wants to hear. An obvious example is where the auditor does not agree with the client's interpretation of a particular accounting standard, or where there is significant uncertainty over whether the client can continue as a going concern meaning the auditor needs to draw attention to this in his report. Giving such 'unwelcome advice' is entirely right and proper, and increased competition would not make it any easier for clients to obtain advice they liked (i.e. agreement with an incorrect accounting treatment) so long as accounting, auditing and ethical standards were correctly applied by audit firms.

There may however be an issue in terms of the numbers of firms that advice can be obtained from in other areas – for instance if a banking company wishes to obtain a second opinion in respect of a particular taxation issue. In this instance there will be relatively few firms that can be approached which inevitably does restrict client choice in this area.

5. What is the role of auditors and should it be changed?

The role of an auditor is, quite simply, to report to the members of the entity whether the financial statements give a true and fair view. This is the statutory purpose of an audit and we do not believe that there is any need for a change.

There have been calls recently for more detailed reporting by auditors, for instance expanded audit reports with more detailed discussions of audit issues. This call has come largely from the institutional investor community. However, the vast majority of UK companies simply do not have any institutional investors and any re-think of what the audit report contains, or the wider role of the auditor, must take account of this and not enforce additional burdens on auditors in providing an expanded report, or service, to clients who neither have a need for it or want it.

Moreover, the auditor's report is prepared as a result of the auditor's statutory requirement to report to the members and for no other purpose. Any expansion of the auditor's role risks creating a wider duty of care which would make it even more imperative for a workable liability limitation mechanism to be put in place.

As a side point, the provision of additional services – for instance taxation or corporate finance – by audit firms is not itself an expansion of the auditor's role; instead, it is a means of providing the best possible comprehensive service to the client.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

Without examining the audit files of the auditors of major banks, it is impossible to say whether auditors were sufficiently sceptical (or not) in the run-up to the financial crisis. This point appears to be going over ground already covered by the McFall report, which whilst calling for prohibitions on non-audit services, did not conclude in any way that auditors were to blame for the crisis. There is no suggestion that the audit profession was at fault and therefore no need to query the level of scepticism generally exercised. Professional scepticism is a key principle which underpins how audits are performed and although there has been public comment about auditor scepticism as well as comment from the Audit Inspection Unit (leading to the issue of an Auditing Practices Board discussion paper) it is debatable whether there is any hard evidence of pervasive issues.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

Other than exercising their usual professional rigour when performing audits, it is difficult to see what auditors could have done to mitigate the banking crisis or how they could contribute to better supervision of banks. As noted above the role of an auditor, including the auditor of a bank, is to express an opinion to the members on the truth and fairness of the financial statements. The auditor has only failed in that role if something has not been brought to the attention of members that should have been, for instance going concern worries or an incorrect accounting treatment.

Clearly banks and other major listed companies have a public profile but the auditor has no duty of care to the general public; in any event, the accounts of such companies are available to the general public on their websites.

8. How much information should bank auditors share with the supervisory authorities and vice versa?

This will inevitably depend on the outcome of question 5 and must necessarily take into account the primary responsibility of auditors and their principal duty of care. Obviously for financial services clients there are already additional requirements for auditors to report to the FSA in respect of certain matters.

9. If needs be, how could incentives to provide objective and in some cases unwelcome advice to clients be strengthened?

We do not believe that any additional incentives are necessary as audit firms should already be providing objective advice – even if it is not what the client wants to hear – if they are applying professional standards properly.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

We would stress that a mechanism for avoiding or mitigating conflicts of interest between audit and non-audit services – which includes consultancy – already exists in the form of the Ethical Standards for Auditors and specifically Ethical Standard 5 which covers the provision of non-audit services to audit clients. If applied properly the Standards are effective in addressing such issues. Indeed there is no evidence whatsoever that the provision of non-audit services by audit firms has had any adverse effect on audit quality. Rather, the provision of non-audit services by auditors results in the provision of a better service to the client.

This is clearly an issue which has been the focus of adverse comment in recent years particularly in the wake of Enron however it remains the case that auditors can provide non-audit services, including consultancy (which is an extremely broad term that can cover a wide variety of different services) so long as potential conflicts are identified and managed.

11. Should more competition be introduced into auditing? If so, how?

As noted in respect of the earlier questions, the issue is really whether more competition is needed for the audits of major listed entities, not whether it is required across the board, as for other entities the dominance of the Big Four is much less of an issue.

We do not believe that it will be possible to achieve more competition in the banking audit sector unless either a break-up of one of the Big Four takes place or a large number of their specialists (together with some major clients) defects to another firm. This is because of the

level of specialist expertise required to audit banking entities, which will otherwise be extremely difficult for other firms to obtain.

We do, however, believe that there is scope for more competition to be introduced for the audit of other major listed entities because the mid tier firm are capable of serving such entities. The difficulty will be in convincing such entities that they do not need a Big Four auditor and this is something that would be difficult to achieve through statute. There may be mechanisms which could achieve better visibility for other audit firms to audit committees, for instance requiring all companies listed on the London Stock Exchange (except banks for the reasons noted above) to tender for new auditors every five years, and to include at least one non-Big Four auditor on the tender list; this would allow the mid tier, should they wish to, a chance to demonstrate their capabilities without enforcing any more draconian requirements such as mandatory rotation of auditors, which we believe would be counterproductive and lead to a reduced level of client service.

In terms of mechanisms which could be introduced through statute, as noted above the key mechanism to improve competition would be to agree a workable mechanism for limitation of auditor liability so that the risks of entering the market do not outweigh the benefits. It would also be beneficial to prohibit 'big four only' (or indeed any size restriction) clauses in a company's governing document or in banking covenants.

However, as noted in section 1, at present we believe that mid tier firms may well consider that the risks of taking on major listed entity audit work outweigh the benefits of doing so. This issue must be addressed as a priority. We would also stress, as noted in our introduction, that the larger firms (and the profession as a whole) make a significant contribution to the UK's gross domestic product and such businesses should be encouraged to grow not only by encouraging competition but enabling them to service their clients without putting unnecessary barriers in their way as a result of misperceptions.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

The role of the internal auditor is essentially that of an internal control and as such the external auditor may, or may not, place reliance on this control in the same way as any internal control. The role of internal audit and the scope of what internal audit does necessarily depends on the particular entity and indeed many smaller companies. including smaller listed companies, do not have an internal audit function. There does not seem to be a particular need to enhance the role of internal audit.

13. Should the role of audit committees be enhanced?

Following the consultation on non-audit services, there is likely to be an increased role for the audit committee in approving non-audit services supplied by the auditor to increase perceived transparency and make it clear that the entity, as well as the auditor, has

considered any perceived or potential problems arising. As a result the FRC has proposed revisions to its guidance for audit committees. It is difficult in reading this question to know what the Committee has in mind other than this proposed enhancement.

14. Is the auditing profession well placed to promote improvement in corporate governance?

The auditing profession can certainly assist in promoting good corporate governance, for instance advising clients on the extent to which their corporate governance does or does not comply with the Combined Code, and sharing examples of best practice. The profession also can and does assist by providing feedback on proposed new corporate governance requirements when they are still at a draft stage.

In summary, we would stress again that there is no evidence of systemic issues with audits and that the level of regulation already in place, together with the inability of the profession to limit its liability in a meaningful way, is profoundly inimical to competition in the audit market and needs to be addressed urgently.

8 September 2010

Letter from Mr Keith Labbett

I attach a response to your invitation to submit evidence to the enquiry on auditors. The evidence represents my individual view and reflects on practice from within my organisation, where I am the Head of Audit, and others.

I have provided comment and ideas to those questions that apply to this organisation. These comments should be put in context to the size of my organisation, which has a £200m turnover and total assets of around £670m. This places us roughly as FTSE 350 equivalent.

I refer to a three tier governance model introduced in my organisation which may be of wider application in helping sort out and clarify roles and responsibilities of internal auditors, external auditors and the audit committee. In case it helps with understanding my points, I therefore also attach a schedule summarising our three tier governance model.

Memorandum from Mr Keith Labbett

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1 Question 1: cause of concentration

1.1 It is suggested that concentration of references to the Big Four creates the perception of a restricted market and may create an unnecessary Barrier to entry. We have found the perceived restriction in the market unfounded.

1.2 We had, for many years, selected our external auditors from the largest eight accounting firms. In 2005, with fewer large firms, we extended the invitation to those outside of the Big Four to submit proposals for the external audit service. A firm outside of the Big Four was selected. This was because the proposed service levels outstripped the quality of service previously supplied to us and at lower rates. Five years on, the annual assessments of the external auditors by the Audit Committee have shown that the proposed service levels had been met each year. The extent and quality of value added services received from the previous auditors had not lessened and indeed, in some areas, the level of advice has increased.

2 Question 2: fees

The fee levels we pay have not been restricted by a lack of competition. While there may be insufficient competition between the Big Four we found adequate competition available outside of the Big Four. In the appointment competition, we found the fees proposed by firms in the Big Four were noticeably higher.

3 Question 3: objectivity

We found that there was no lessening of objectivity following the appointment of a firm outside of the Big Four. The firm's internal quality review arrangements provided us with assurance.

4 Question 4: unwelcome advice

Our observation comparing current and previous auditors is that the flow of advice, including that of an unwelcome nature, the extent of challenge, the content of the management letter and communication with stakeholders has not been affected. Indeed, this has reinforced our decision to make a change of appointment.

5 Question 5: role

It is necessary to read the whole annual report, including the Operating and Financial Review, to make an assessment of the performance of the organisation. As assurance on the annual report, it would be useful for the Board and stakeholders if the external auditors were to provide a summary of their view of the effectiveness of governance and management of risks to the corporate objectives as well as their conclusion on the accounts. While the Board determines the level of risk it is willing to take, the external auditors could usefully report whether the risk management framework was appropriate to the level of risks.

6 Question 6: banking scepticism

No comment.

7 Question 7: banking crisis mitigation

As part of their annual audit, our auditors have assessed the cash flow for the coming twelve months and the banking covenants against potential performance. With some significant projects having a longer development period, there may be merit to extending the review of cash resources beyond a 12 month horizon.

8 Question 8: sharing with supervisory bodies

No comment.

9 Question 9: incentives to provide unwelcome advice

There may be merit in requiring regulators to enquire of auditors whether or not they ascertained the reasons for any change in market performance of the company and whether they can demonstrate that such views had been shared with the company.

10 Question 10: consultancy

There is a difference between consultancy as added value to the company based on items observed during the external audit and consultancy in lieu of management identifying a recommended course of action. The first type of consultancy may not impact on subjectivity and, if performed within pre approved cost limits, may demonstrate their involvement in the management decision was limited. The second type of consultancy may have a significant impact on the organisation and, if performed by the external auditor, may be seen as affecting their objectivity and independence from management action. The size of any consultancy fee may also affect the perception of the objectivity and independence of the external auditor.

11 Question 11: competition

The issue is partly because of use of the term Big Four. It may be an unnecessary extra level of certification to set down criteria that allows smaller firms to be assessed by the market as competent. Instead, market perceptions and practice may change if the term is widened to include firms that audit the FTSE350, say.

12 Question 12: enhancing the internal audit role

12.1 Internal Audit is a function of scope, standing and capabilities and the strength of the surrounding governance process. It is the eyes and ears of the audit committee. Current practice is for audit committees to approve the scope of internal audit and its plan of work. It would help if best practice was for the audit committee to approve the appointment, resourcing and reward of internal audit.

12.2 Internal audit value to an organisation increases as the extent of its strategic coverage widens and as the management level reading the audit reports increases. Such internal audit provision can be provided by a small team of management literate auditors and should be seen as distinct from the checking and monitoring functions which should rest within management. In essence, we would strongly advocate the three tier governance control model as an effective way of enhancing the role of internal audit. [23]

12.3 Internal audit, as an informed source of information of corporate priorities and processes, could assist the external auditors in understanding and planning their work. The external auditors could use the model to assess where they could place reliance - not just for reliance on internal audit but on the wider control process.

13 Question 13: audit committees

[23] In the three tier governance model, Level 1 control is the ongoing checking of transactions, Level 2 is the monitoring of the checking process to determine improvements, and Level 3 is the overview provided by the audit committee and internal audit function.

While many audit committees may not need any incentive or support, there may be merit in identifying why some audit committees are effective. A driver for effectiveness may be from greater visibility of the work and coverage of the audit committee. This could be detailed in the annual report, on the organisation's website and at the annual meeting. Often, the ability for an audit committee to provide adequate challenge depends on its sources of quality, relevant information. This should relate to reviewing the key management reports, rather than restricted to the external financial statements. Further enhancement could be by extending a statement that it had undertaken a review by providing the extent of its findings on such a review. This could be applied to compliance with regulations and to risk management.

14 Question 14: promoting governance

The profession, lead by the Institutes, should be well placed because of the number of its members employed in relevant positions within organisations and also with its network for influencing leaders. This role may weaken if the Institutes focus more on financial aspects rather than business performance.

Memorandum from Mr Keith Labbett

Governance control model: showing how the Executive is supported by a three tier control: delivery unit - functional specialists - audit

Executive

Accountability: Executive reports to the Board

Plan: address foreseeable demands, setting resulting business planning assumptions followed by preparing a three year corporate plan
Do: set targets, approve standards, mandatory processes and competences
Monitor: forecast reviews, identifying changes to plan
Correct: revised forecasts and actions followed though to implementation

1st control tier Audit

Accountability: Audit Committee assesses effectiveness of controls over business risks

Plan: Audit Plan covering major risks to the corporate plan over a three year period
Do: report level of assurance to the Audit Committee
Monitor: Audit Committee oversight of the results and that the proposed actions accurately deal with the cause of risks
Correct: monitoring of timely implementation of management actions

2nd control tier Central functional specialists - technical, safety, heritage, environmental, personnel, finance, customers

Accountability: setting and monitoring standards

Plan: propose process, standards, competences having agreed the resource impact
understanding the external environment that might impact on standards and priorities
Do: publish process and task definitions with accountabilities clearly allocated
Monitor: validate business unit reported achievements of targets and compliance with standards including competence by personal observation and testing. Frequency of monitoring adjusted by extent of non achievement.
Identify trends, systemic weaknesses, training need, lack of clarity in processes, changes in business and customer relevance, simplification opportunities
report to Executive on reliability and integrity of unit management reports using tools such as league tables, traffic light reports and lead and lag indicators.
Correct: revise standards, revise process and tasks as a result of best practice, innovation and continuous improvement
refer up unmanaged risk

3rd control tier Delivery unit - local business units, shared services, commercial teams

Accountability: delivering targets and standards.

Plan: undertake risk assessments to determine proportionate level and frequency of action
Do: delivery function: follow process and task definitions
ensure people have appropriate competences
identify areas for efficiency and innovation including process improvement
Monitor: measure targets and standards and check their reliability and integrity by personal observation and testing. Tools include, operating statement, lead and lag indicators and traffic light reports from Central Functional teams

	report measures to Executive
Correct:	identify corrective actions and timetable, redirect resources, and follow up implementation
	refer up unmanaged risk

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Memorandum by Professor Kevin McMeeking[24]

Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1. Auditing is ***not*** concentrated on four global firms in all segments of the market. The level of concentration varies from one country to another and increases with entity size. Small and medium sized accounting firms compete effectively for the contracts of unlisted entities and small listed companies in the UK, in some cases winning contracts where there is no requirement to have an audit because the company is below the size threshold. Small and medium sized accounting firms also have an active presence in the medium size listed company market in the UK and across all listed companies in many countries.

2. In the UK, the Big Four accounting firms provide the audit and consultancy advice for virtually all of FTSE350 market. Small and medium sized firms are unable to effectively compete in this segment of the market for a number of reasons. From a supply side perspective, the mergers between the leading accounting firms and the demise of Andersen contributed significantly to the increase in concentration. Consistent with signaling theory, the Big Four accounting firms promote themselves as industry specialists (Zeff and Fossum, 1967; Danos and Eichenseher, 1981, 1982), using the popular press and their websites to advertise their expertise in specific industries and to claim to provide a higher quality service and greater value (Berton, 1995). From a demand side perspective, companies have become more globalised and their control systems and financial statements have increased in size and become more industry specific. Multinational companies have increasingly sought the services of a brand name firm that offers higher (industry specialist) levels of audit performance and expertise beyond the generic level mandated by statute (Shockley and Holt, 1983; Bonner and Lewis, 1990; Ashton, 1991) and is able to significantly reduce industry-specific agency and other costs (Jensen and Meckling, 1976). Companies are willing to pay a premium for the services of a brand name audit firm (McMeeking et al., 2006) which may be more capable of mitigating earnings management (Krishnan, 2003).

Does a lack of competition mean clients are charged excessive fees?

3. Industrial economists argue that market structure is intrinsically linked to firm behaviour and financial performance. Scholars urge regulators to be wary of the pricing effects of increases in market concentration (Scherer and Ross, 1990; Stigler, 1968; Gist and Michaels, 1995; Romeo, 1999). The extant literature on the welfare effects of mergers on the economy is mixed (Francis et al., 1999). Consumer welfare will increase if mergers reduce marginal costs, create efficiencies and enhance product differentiation but will decrease if mergers enable tacit collusion over prices or if unilateral anticompetitive effects arise from non-tacit price collusion (Sullivan, 2002).

4. Studies argue that the high concentration has not improved the level of price competition in the UK audit market (Oxera, 2006; McMeeking et al., 2006) but without cost data it is difficult to test whether accounting firms are engaging in anticompetitive pricing

[2424] This paper summarises the opinion of Associate Professor Kevin McMeeking, of the University of Exeter, on an individual basis. The paper responds to the questions raised by the committee drawing from the academic auditing, financial reporting and corporate governance strands of extant literature. I am grateful for the helpful comments of Professor Peter Pope but take sole responsibility for any remaining errors.

strategies. Companies are free to change auditors if they feel they are being overpriced, assuming that there is a viable alternative, although the significant switching costs for both the company and the auditors may explain why the rate of rotation (around 4% p.a.) is very low.

Does a narrow field of competition affect objectivity of advice provided? Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

5. Choice and the governance of accounting firms have attracted more attention in recent years than pricing (Financial Reporting Council, 2007; Murray, 2010; Abidin et al., 2010). The limited choice, which is as low as one accounting firm in some industries, is often attributed to desire for specialist advice. This lack of choice could provide accounting firm with the opportunity to exercise monopolistic pricing and/or reduce the quality of the advice offered. If poor assurance is defined as an entity that enters into insolvency proceedings or is bailed out by the government shortly after receiving a clean audit report then the size and scope of recent failings suggests that there is an association between choice and the quality of advice.

6. This potential quality issue has been exacerbated by the acknowledgement of the FRC, SEC and PCAOB that they cannot afford to lose another Big Four audit firm. The Big Four used the market uncertainty, threatening a 'four to zero' scenario to leverage favourable legislative changes in the form of a cap and proportionate liability (McMeeking, 2009; Sikka, 2006) which if not carefully monitored may cause audit firms to cut corners in the interest of profit. It is not clear whether the regulatory bodies have a plan for ensuring the integrity of financial information if the current model collapses. Critics argue that the Big Four firms are 'too big to fail' (Greenwood and Suddaby, 2006) do not fear being indicted, and is worryingly reminiscent of the banking sector prior to the crisis. Since the partners are heavily exposed on an individual level, the assurance provided by firms that are severely strained financially and strategically by the size of pending litigation may be compromised and there is a significant risk that leaders spend most of their time addressing, evading or settling claims rather than improving audit quality. The potential for another major failure will always exist because personal gain may cloud professional judgement and ethical values. The firms, institutes, regulatory bodies and universities have a vital role in stressing the virtues of ethics, professionalism and high quality assurance, particularly in this period of economic uncertainty.

What is the role of auditors and should it be changed?

7. The auditor's role is to be a gatekeeper, a watchdog not a bloodhound. Although auditors work for the shareholders, the relationship is unusual because the company contracts with them and pays the fees. Auditors have a public duty to shareholders but there is a risk that they may become too close to management. I do not envisage any major changes in the role of the auditor in the future.

Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor? What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

8. The scale and scope of the financial crisis and the scarcity of unqualified audit reports suggests that audit firms were not sceptical enough prior to the crisis. It is difficult to say that a lack of competition caused the crisis because of the limited counterfactual evidence but the financial services market had an extremely limited choice of auditors and was worse hit than other sectors. It is vital that auditors act as gatekeepers, any methodological failings are removed and more audit effort is exerted if confidence is to be fully restored in the market. If accounting firms respond to the economic downturn by cutting corners on audits then further problems are inevitable.

9. All of the blame for the banking crisis cannot be levelled at the audit firms. The lack of understanding of new financial products, particularly credit default swaps, also had a major role to play in the economic downturn. Management are responsible for reporting the size and scope of the risks that their entity is exposed to. Whether through ignorance or avoidance several banks failed to acknowledge and/or disclose sufficient information about the credit and liquidity risks associated with their financial instruments. More work is required to improve the quality of financial reporting (e.g. IAS32, IAS39 and IFRS7) for both financials and non-financials and the education and training of directors in the area of financial instruments.

10. The banking crisis represents a failure of corporate governance. Following previous scandals, considerable effort has been expended on improving the corporate governance of companies (Combined Code). Although accounting firms do not have the same separation of ownership and control issues that companies possess, similar best practice requirements have been introduced for the eight leading accounting firms in the UK (the Murray Code). It is not clear a priori whether the Murray Code will improve corporate governance. For example, the appointment of non-executive directors should improve governance if the best individuals are chosen that are able and willing to contribute to the operations and decision making of the firm. Regulators can then consider the cost/benefit implications of rolling the Murray Code 'best practice' to small and medium sized accounting firms. On the other hand if the eight leading accounting firms recruit individuals that lack independence, pedigree, application or attention to detail, then this aspect of the Murray Code will not improve corporate governance.

Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

11. There are clear potential conflicts of interest between audit and consultancy roles that have the potential to impair independence. These issues have been highlighted many times, most notably perhaps in the Sarbannes Oxley Act: "*They (Auditors) also performed significant non-audit or consulting work for the companies they audited. Many of these consulting agreements were far more lucrative than the auditing engagement. This presented at least the appearance of a conflict of interest. For example, challenging the company's accounting approach might damage a client relationship, conceivably placing a significant consulting arrangement at risk, damaging the auditing firm's bottom line*." The only failsafe solution to minimise these conflicts is to prohibit the provision of consultancy advice by accounting firms to their audit clients. Accounting firms have long argued that they are best placed to provide consultancy advice and they have 'Chinese Walls' to segregate their audit from consultancy wings. However, critics have long cast doubts about the validity of these segregation claims. Prohibition may improve independence but will not enhance choice if the consultancy contracts of large companies are cross referred amongst the Big Four.

12. An alternative solution is to require companies to disclose the fees paid to auditors and other firms for consultancy work on both individual audits and at firm level. Shareholders that take an active role in the stewardship of the company can decide with the audit committee whether or not the existing provisions are appropriate. This is a less draconian measure but requires the input of stakeholders in the corporate governance process. One problem with this model is that accounting firms have the potential to manipulate their figures because audit and consultancy advice may overlap.

Should more competition be introduced into auditing? If so, how?

13. It will take many years, if it is possible at all, to increase competition in the large company audit market using market measures. The Market Participants Group annual reports indicate that there has been little if any improvement in choice since the publication of the Oxera report. The Market Participants Group will continue to monitor developments but the lack of change in the market is unsurprising (McMeeking, 2009). If improving choice is deemed essential to improved corporate governance, an alternative option is for regulatory bodies to intervene and break up the Big Four. This would be controversial and possibly problematic (requiring the authority of regulatory bodies across countries) but it has been enforced in Japan (Accountancy Age, 2006) and might improve quality by overcoming the 'too big to fail' issue.

Should the role of internal auditors be enhanced and how should they interact with external auditors? Should the role of audit committees be enhanced?

14. I believe that the role of internal auditors and audit committees is appropriate but there is scope for more active engagement and interaction with external auditors.

Is the auditing profession well placed to promote improvement in corporate governance?

15. The auditing profession is well placed to improve corporate governance. Altering the mindset of auditors, company directors and banks is fundamentally important to the prevention of future scandals. The search for high yields, short term strategies and a reduced cost base is excessive risky and must be overturned to improve the sustainability of the business entities.

September 2010

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Letters from Mazars LLP

Mazars, the integrated international accountancy organisation is pleased to submit its evidence to the Select Committee's enquiry into the above issue.

The importance of statutory audit

Statutory audit is a fundamental element of good governance. It provides assurance to shareholders on the stewardship of their businesses and plays an important role in ensuring confidence in the capital markets. We recognise the privilege afforded to us as a firm in being registered to undertake statutory audits and firmly believe that with this right comes the obligation to help foster an open vibrant audit market that is responsive to the needs of shareholders and the public interest more widely.

Extending the auditor's role is dependent on confidence in the core audit

It would be helpful to review the scope of the audit and whether this should be extended to encompass additional assurance on areas such as risk and other aspects of narrative reporting. We recognise, however, that support for such a move will only be forthcoming if

there is a strong level of support from investors, regulators and others for the way in which the core statutory audit is operating with regard, for example, to how auditors report their findings and the structure of the audit market.

A more competitive market needed to protect the public interest

A more open vibrant audit market, especially for large listed companies, would better serve the public interest. It would reduce the potential negative risks were one of the currently dominant four firms to leave the market unexpectedly and would also, in line with experience in other sectors, be likely to lead to audit firms as a group being more innovative and more responsive to shareholders' needs.

A stagnant audit market for large listed companies, not changed by voluntary initiatives.

Figures calculated from independent research by Oxera and published by the Financial Reporting Council in 2006 indicate that a FTSE100 auditor can expect to remain in place, on average, for a period of 48 years, with some having held office for over a century, and those in the FTSE250 for 36 years. , Oxera also found that more than 70% of the FTSE 100 had not put their audit out to tender for *at least* 15 years.

As the fifth progress report from the Financial Reporting Council on the implementation of the recommendations of its Market Participants Group highlights, the change to the above state of affairs brought about by market-led initiatives has been disappointing. It is now time to move on from a purely voluntary approach.

Key areas for reform- fair tendering, more shared audits, no restrictive covenants

To address the situation outlined above, we believe reforms are needed to bring about, in particular, fair and regular tendering; greater use of shared audits and an elimination of restrictive covenants.

Fair and regular tendering

Large listed companies, as they constitute the part of the market with both the greatest concentration and the highest related systemic risk, should be expected to tender their audits at regular intervals. Without this change, the opportunities for a firm to increase their market share, whether one of the existing leading players other than the Big 4 or a new entrant, are extremely limited.

Consideration also needs to be given to the arrangements to be made when audits are put out to tender. For listed companies, these might involve publishing tenders to ensure firms with the necessary capabilities are able to tender and having a two stage process providing for the submission of a short document at the first stage by a number of firms from which a shortlist would be selected for the final presentation. Arrangements for the independent oversight of tendering might also be helpful.

More radically, exploration for alternative methods of appointment of auditors by, for instance, independent shareholder panels could also be explored.

Shared audits

We strongly support considering how to actively promote the involvement of more than one firm in the audit of large listed groups. Innovative thinking is needed and the participation of each of the shared auditors may take a number of different forms. For example, one of the shared auditors may perform the statutory audits for certain subsidiaries.

Joint audits, where two firms, take full joint responsibility for the audit opinion offered, are a particular form of shared audit. We believe there would be merit in requiring leading banks in the UK to appoint joint auditors given the systemic risk involved, the complexity of their operations and the inherent subjectivity in their financial statements.

Conclusion

Our response to the detailed questions is set out in the attached appendix.

24 September 2010

Appendix

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1. There are some economies of scale in relation to the auditing of, for example, listed companies but they do not explain the current levels of concentration in the audit market for such companies especially at its upper end. Investment is clearly needed in areas such as the provision of technical expertise, training and development, the development and updating of audit methodologies and the maintenance of quality control systems and those related to independence. Significant investment has been made by our firm and a number of other firms in this area and thus the existence of some economies of scale cannot be used to justify the dominance of the largest four firms. There may also be some diseconomies of scale with respect to the largest firms due to their significant overhead structures covering areas other than those related to ensuring the quality of work undertaken. Moreover, the geographical coverage of Mazars and the main networks outside the Big 4 is sufficient to enable us to deal with the vast majority of listed companies.

2. Auditing has become very concentrated amongst the Big 4's global networks, each made up of a number of independent firms, due, for instance, to the absorption many years ago of regional firms by the leading players to create what at the time were the eight largest nationwide firms in the UK; the subsequent absorption of a number of mid-tier firms by the larger firms; the merger of some of the larger firms themselves and finally the collapse of Arthur Anderson in the wake of the failure of Enron, leading to the emergence of the Big 4. On the demand side, we understand that some investors and advisers have encouraged companies to appoint a Big 4 firm when first joining the listed market or subsequently. As large listed audits rarely come up for tender, there has been ratchet effect on concentration – it has steadily increased over time with little prospect of it reversing.

2. Does a lack of competition mean clients are charged excessive fees?

3. Any views on whether clients are charged higher fees than they would be in a more competitive market will tend to be inherently subjective as audit fees will always be dependent to some extent on company- specific factors in a given accounting period and over a period of years fees may vary due to both changes in the internal environment of the company and in the external marketplace, for example, as a result of the introduction of new accounting standards or changes in company law. That said, it would generally be expected that if there were more regular market testing of fees through tenders and a greater choice of firm that this would have an impact on audit fees.

3. Does a narrow field of competition affect objectivity of advice provided?

4. We do not believe that the lack of competition would lead any firm to offer advice that was other than professional.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

5. We are not persuaded by any suggestion that limited competition makes it easier for the auditor to provide unwelcome advice.

6. This and the previous question seek to elicit views on the relationship, if any, between the objectivity of advice and the degree of competition. We would suggest the enquiry should also have regard to related issues such as the relationship between the quality of service and the degree of innovation on the one hand and the degree of concentration amongst the dominant firms on the other.

5. What is the role of auditors and should it be changed?

7. The current primary role of the auditor is to express their view on whether the financial statements show a true and fair view for the period covered by the audit. There are additional responsibilities relating to checking whether the financial statements are in accordance with the underlying accounting records, to the director's report and to separate corporate governance statements (with regards to the Transparency Directive).

8. There has been recent discussion on whether the role of the auditor should be widened to encompass reporting, in some form or other, on matters related to the principal risks of the company and how they are being managed and also possibly to some other aspects of narrative reporting, eg concerning discussions of business performance and future prospects. We think these issues should be fully explored, as should assurance on sustainability issues, but it is vital that this be done by reference to which reforms would best serve the public interest and, within that, those of shareholders. Matters to be considered include which areas of reporting should be covered by any additional assurance requirements; what form of assurance would shareholders find to be of real value, eg on the processes undertaken by the board in the relevant area or on the outcomes: whether any additional assurance should form part of the statutory audit or represent a separate assignment; what would be the cost of providing the additional assurance and whether the additional costs involved are outweighed by the expected benefits?

9. Before considering extending the scope of the audit it will also be essential to ensure that shareholders, including in particular institutional shareholders, have full confidence in the current core audit . This includes considering what is the most helpful way for auditors to report their findings or, alternatively, whether the audit committee should

report on issues it and management have discussed with the auditor who could confirm his or her agreement with the disclosures made.

10. There would be merit in discussing whether there is concern that the exercise of judgement in arriving at the audit opinion on truth and fairness has been reduced in recent years by greater emphasis on reporting and auditing standards.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

11. We are not in a position to comment on this issue as we do not have access to the necessary information. We are, of course, aware that the FSA and FRC have published a paper on this issue.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

12. We consider that the introduction of joint audits would provide additional audit assurance in respect of leading banks and could be justified for them on the grounds of the systemic risks involved in their operation; the complexity of their business and the inherent subjectivity of their financial statements.

13. With regard to whether the auditors could have helped to mitigate the banking crisis, we would observe that the peak of the banking crisis occurred some months after the auditors had reported on the last set of annual financial statements for the leading banks and that the drying up of liquidity in the financial markets had not happened for an extremely long period. Moreover, when it manifested itself during the crisis it did so with relatively little notice.

8. How much information should bank auditors share with the supervisory authorities and vice versa?

14. We support effective two-way liaison between the regulators of banks and their auditors. Each has access to information not available to the other and so gaining the full picture requires consultation between them. In appropriate circumstances it may be helpful also to involve the financial institution in such dialogue although there is likely to be benefit in some discussions taking place just between the regulator and auditors. Some of these discussions would best be on a collective basis between the regulators and the auditors of all the leading banks together at which sector trends, their impact and the regulator's general concerns could usefully be discussed. In addition, we would expect appropriate one-on-one discussions between regulators and a bank's auditors on bank-specific matters at appropriate times in the year, eg after the conclusion of the audit though, if circumstances merit it, meetings should naturally be held whenever necessary.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

15. We believe that fulfilling professional obligations rather than incentives should be the primary driver for providing high quality objective advice whether welcome or not.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

16. Conflicts of interest can clearly arise between audit and consultancy roles. Ethical standards require that the audit partner should determine whether any proposed additional

services provides a conflict of interest, including a perception of one, and that where this is the case the potential assignment causing it should not be taken on unless appropriate safeguards are first put in place. Notwithstanding the above, the provision of certain services by the audit firm is prohibited.

11. Should more competition be introduced into auditing? If so, how?

17. For the reasons discussed in the covering letter, we strongly believe that it is essential in the public interest for substantially greater competition to be introduced as a matter of priority.

18. It is now clear that voluntary initiatives in this area are not achieving the desired results but if we thought the necessary change could be achieve through, for example, a robust code, eg the UK Corporate Governance Code, which was properly monitored such an approach may have merit. The issue is a European and global one, as well as a UK one and this needs to be taken into account in determining the best way forward. We believe a package of reforms will be needed and should probably include:

- leading listed companies being expected to put their audit out to tender at regular intervals;
- fair tendering processes that have proper regard to the capabilities of all appropriate firms
- more use of shared auditors in the case of leading listed companies, including joint audits for banks

19. Other initiatives that it may be helpful to explore include alternative appointment processes for auditors, eg involving shareholder panels, and even limiting the number of listed audits any one firm may hold.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

20. Internal audit has a vital role to play in the overall assurance framework relating to large businesses. We believe there would be merit in setting out in a little more detail in the UK Code on Corporate Governance the role of the internal audit function and appropriate reporting lines which emphasise its independence from management. The primary reporting line should be to the chair of the audit committee. We also consider the head of internal audit, assuming the function is not outsourced, should have a level of seniority equivalent to that of a member of the senior management team or an executive director on the board.

21. If the external auditors are satisfied as to the level and range of skills of the internal audit team; the adequacy of the resources available to them and the independence of the internal audit function they should be able to place reliance on its work and take this into account in determining the amount and nature of external audit work to be undertaken.

13. Should the role of audit committees be enhanced?

22. We consider the UK Code on Corporate Governance and the supplementary guidance for audit committees contains significant guidance on the role of audit committees and on key issues impacting on their effectiveness.

23. Whilst the guidance available is generally adequate, we would encourage audit committees to review how it is implemented in their company and to give particular attention to behavioural and cultural issues in order to ensure the committee is achieving its full potential.

14. Is the auditing profession well placed to promote improvement in corporate governance?

We believe the auditing profession is one of the players with an important role in promoting improvements in corporate governance. As a firm we seek to do this through the provision of assurance services and those on board and audit committee effectiveness, risk management and internal audit and through the development of publications and organising of events to disseminate best practice.

Memorandum by Mr Cliff Moggs

"The need for openness, providing transparency to increase confidence."

Preface.

It took only one Engagement Partner to bring about the demise of Arthur Andersen in the Enron scandal. USA legislation created the 'formal approval of the audit opinion' by a process under the responsibility of the Engagement Quality Control Reviewer. The profession remains relatively quiet on this responsibility and the work performed. Regardless of the size of an audit firm these two individuals significantly influence the confidence in the market for the work undertaken. Are there not two impacts that with ease can bring about significant improvement in the process of an audit of financial statements?

Discussion.

Two changes to current behaviour will provide greater confidence from the work of the audit. It is based on 'openness enabling transparency leading to increased confidence in the published results'. Both parties contribute in changes to culture for the entities and the auditors; in being open, it creates transparency, knowing will establish confidence for the work performed. It will be in the public domain open for observation and criticism.

The audited entities will release the fact that auditor changes were made or not made to the financial statements as prepared by the Board of Directors before an audit opinion was approved for release. In so doing shareholders will be informed as to why changes, if any, were necessary. This facilitates transparency of the differing view and reasoning for understanding. For those entities that demonstrate corporate integrity in the preparation of their financial statements clear recognition will be acknowledged by this clarity. Shareholders will have increased knowledge of the work of the Board of Directors in its ability to present financial statements that are worthy of an unqualified opinion. The sceptical assessment by an independent auditor approved by the Engagement Quality Control Reviewer ratifies the Boards judgement of its financial position.

On the audit side; it is a requirement that before release of the proposed opinion the Engagement Quality Control Reviewer (EQCR) will have examined all of the Engagement Partner's (EP) critical judgements and evidence used to arrive at their proposed opinion. However, there is no public (open) recognition that the EQCR granted their approval to enable the EP to issue the opinion. The work of the EQCR and name can quite easily be as

an appendix to the auditor's opinion statement. It is interesting to note that in the USA "Sarbanes-Oxley Act of 2002" Section 103 (part) quote "provide a concurring or second partner review and approval of such audit report……" This addressed the issue of the Arthur Andersen EP rejecting AA's expert opinion on specific accounting treatment in the Enron scandal. Although this is now part of the audit standard on Quality Control (ISQC 1) the language used is passive and "approval" is excluded from the definition of the EQCR's responsibility; whereas the definition of the EP is complete.

Perhaps a 'step too far' would be to re-look at the 'proposal' made by Alex Arthur (Dept of Accountancy & Finance, Univ. of Aberdeen). His suggestion was to 'untangle and re-arrange the relationship between directors, shareholders, auditors and professional liability insurers (PII).'

PII's would sell to Directors indemnity insurance to cover themselves against shareholder's claims for false accounting (The auditors no longer need PII and the PII fees are now collected from the Directors who pay from funds of the not needed audit fee). The 'auditors' now earn their fees from the PII who engages them to be risk assessors (auditing the entities financial statements and internal controls).

The auditors are now truly independent and the Directors can advise their shareholders the 'cost of indemnity insurance' to cover for falsification of the financial statements. The entities financial statements would carry the PII's risk assessment category. In that the 'liability insurers' pick up the tab anyway they benefit from having the risk assessment task considerably simplified.

The first step of 'openness, transparency, confidence' could be accomplished in essence overnight. This in itself would minimize market firm concentration concerns by putting the EP and the EQCR in the public domain which coupled with such added knowledge, "were the financial statements changed to enable an unqualified opinion to be expressed?" will lead to increase confidence levels.

The re-alignment of the 'parties' to capture true responsibilities clearly would take longer.

23 September 2010

Memorandum by Mr P J Morgan

Introduction

1. This submission concerns the near collapse of West Bromwich Building Society ("WBBS") at the height of the credit crunch, discusses whether the audit arrangements contributed to that near failure, and makes suggestions for improvements in the audit arrangements for this and other entities.

2. After the merger of the Chelsea with the Yorkshire, WWBS is the 6th largest UK Building Society in terms of gross assets. Though the Nationwide is larger than the other 48 Societies combined, at 31 March 2010 WBBS employed 871 staff and reported assets of over £8.3 Billion.

3. The writer is a member of the Society. He both has an ISA direct savings account in WBBS and is a holder of WBBS Permanent interest bearing shares (PIBS). As a direct result of the near collapse of the Society and the sudden capital restructuring in June 2009, the writer lost virtually all of the value of his PIBS investment. Because of this personal loss and because he has extensive large firm auditing experience himself (PWC), the writer has a keen interest in the subject of the committee's enquiries.

4. The submission is set out under the following headings:

- WBBS business and capital restructurings and the circumstances thereof
- WBBS audit arrangements, their possible relevance to its near collapse and suggestions for improvements
- Responses to questions posed by the call for evidence

<u>WBBS business and capital restructurings and the circumstances thereof</u>

WBBS business restructuring

5. In October 2008, WBBS replaced its CEO and subsequently its financial and commercial directors, the first two executives at considerable severance cost. The new CEO, Robert Sharpe, announced a completely new business strategy which he describes as "back to basics". The main components, according to the 2009 accounts, are: cessation of commercial lending and a new concentration on provision of prime residential mortgages; a drastic reduction in wholesale funding and concentration on retail deposits; a drive to become the UK's most cost efficient society, reducing the cost base by at least a quarter; and to recognise and manage the inherent risk in the balance sheet.

WBBS report significant losses and a capital restructuring

6. The need for change became clear on 12 June 2009, when WBBS announced post tax losses for the year of £39.3 Million, including provisions for doubtful and bad debts of £65.2 Million (see attached accounts).

7. At the same time, it announced an unexpected capital restructuring, the so-called 'Capital Exchange'. The main elements were: (1) holders of £182.5 Million of listed debt would immediately convert all of their debt into Profit Participating deferred shares (PPDS), a new loss absorbing financial instrument created on 1 June 2009 by the FSA for Building Societies, with a 25% share of profits (and losses) in lieu of interest, and (2) interest payable to its £75 Million PIBS holders would in future be restricted to the lower of the coupon (6.15%) and the yield paid to PPDS holders in the previous financial year.

8. The effect of these changes was to increase the Society's core 1 capital ratio from 6.8% to 11.6%. The effect on the market value of listed PIBS was a loss of approximately 85% in their £1 Nominal value. The accounts disclosed that the CEO and FD were paid bonuses of £250,000 in total for saving the Society.

9. In his letter to PIBS holders dated 11 August 2009, the WBBS Chair stated "In order to address the possibility of administration and break up, like Dunfermline Building Society, and the likely adverse impact that this would have on the Subordinated Debt and, by clear implication the PIBS (because they ranked below the Subordinated Debt), the Society's Directors concluded that it was necessary and in the best interests of the PIBS holders and

the Society's other members to agree to the Capital Exchange on these terms." The CEO had earlier told the writer at a meeting on 2 July 2009 that if the Capital Exchange had not been agreed, the auditors would have qualified the accounts on a going concern basis and the Society would have gone into administration.

10. The subsequent AGM on 29 July 2009 was described by one national newspaper (Financial Mail) "as hostile a building society meeting as we have ever seen as one member after another (some three times) stood up to berate the Board." According to the minutes, the Chair conceded, inter alia, that "the Board had certainly not gambled; judgements were made (which dated back several years) which proved in the circumstances over the past 12 months to have been wrong."

11. It is clear that the high risks involved in the previous business strategy became all too apparent in 2008/9. That said, one should always bear in mind that where there has been a complete change of top management and business strategy, as in this case, it is natural for the new management to insist on the maximum provisioning for the costs of the changes in direction.

<u>WBBS audit arrangements, their possible relevance to the near collapse, and suggestions for improvements</u>

Method of appointment of external auditors

12. Whilst the auditors report formally to the members, the appointment of auditors is, according to the regulations applicable to all Societies, on the annual recommendation of the Board. That recommendation is then, effectively, "rubber stamped" traditionally and overwhelmingly (as with other AGM resolutions 90%+) by members' proxy votes. Those proxy votes are lodged prior to any discussions at the AGM and, usually, without sight of the minutes of the previous year's AGM. WBBS AGMs seem relatively well-attended but, even so, attendee members total less than 200, whereas the total voting membership is reported to be over 600,000. Proxy votes on all resolutions are, therefore, of such significance that the Chair of the meeting announces the result of the votes on all resolutions prior to the counting of the votes actually cast at the meeting.

13. The minutes of the previous AGM (normally agreed by the Board at its first meeting after the AGM) are not automatically distributed to members along with the notice of the meeting and voting papers. This is normal practice of course in any large organisation. However, it means that comments made by members at the previous AGM (whether on audit or any other matter) are generally not available to members lodging proxy votes, unless they specifically ask for a copy of the previous minutes. Absence of the minutes of the previous AGM can have an impact on the way proxy votes are cast. As such, it also reduces the incentive for members to attend and make the effort to put forward dissenting or challenging views at the meeting.

14. In effect, therefore, the auditors are appointed annually by the Board, on whose accounts they report.

Relationship between external auditors and members

15. The auditors of the Society for many years have been KPMG. Their formal audit reports (which are addressed to the members) have been unqualified, so far as the writer is

able to determine. It is noteworthy that no questions were raised with the auditors at either the 2009 or the 2010 AGMs.

16. There is currently no forum for concerns to be raised *in detail* directly with the auditors by members as a group, other than at the AGM. The AGM is not an appropriate forum for detailed discussion on technical matters and, in any case, the accounts are approved (by the Board) at that stage. Nor is there any forum on a routine basis, nor incentive, on the part of the auditors, to raise any concerns with the wider membership, the audit appointment being a commercial arrangement, in effect in the gift of the Board (see above).

17. In fact there can be little member involvement with the auditors, unless individual members should take it upon themselves to write to them. As can be appreciated, raising concerns in that way may have limited, if any, effect, compared with open and transparent debate with members as a group.

18. For the committee's information, in this case, the writer has in fact recently written to KPMG to express concerns about several matters of accounting treatment in the WBBS annual accounts and awaits a formal response. Though individually the matters concerned are not that material, the writer is also concerned about the cumulative effect. To be fair to the auditors, KPMG were courteous when initially approached and offered a meeting with the writer to discuss the points.

19. The reason for mentioning this correspondence is that where there are alternative accounting treatments for potentially contentious issues, it would be helpful to members if the auditors have an opportunity to explain, directly to members, the different accounting treatments which could be adopted, the implications of the different treatments, and the reasons for the auditors' decisions. Whilst discussion of such matters no doubt takes place in the Board's audit committee behind closed doors, that is no substitute for direct dialogue with members as a group.

20. Over highly contentious issues, it is in effect often left to the financial press to raise concerns amongst the wider membership and public, etc. For the debate of complex technical issues and "gray areas" of accounting treatments, that is not the most appropriate forum. In any event, in most cases, such issues will not attract media attention.

Possible relevance of audit arrangements to the near collapse of WBBS

21. In the years prior to 2008/9, it is quite possible that the auditors had reservations about the previous business strategy of the Board and the previous management – and hence, the adequacy of provisioning, etc.

22. Thereby the writer does not mean to impugn the professional integrity of the auditors in this, or in any other similar case. It is not the auditors' responsibility to second guess the Board's business strategy. No doubt the ever increasing proliferation of accounting standards and formal guidance (no doubt well intentioned and properly established), together with the size and complexity of organisations like WBBS, have also contributed to a shift in focus in this respect. However, in retrospect, if members had been able to question the auditors' views *routinely*, about the possible implications of the apparently high risk business strategy the Board was pursuing, this may have averted the need for the drastic action subsequently required.

Suggestions for improvements in the member/auditor relationship

23. Such a forum might, for example, be a requirement of auditors to report more comprehensively at the AGM and submit to questions from members? As part of that process, entities should be required by law to circulate minutes of the previous AGM to members (or make them available on their websites) along with the notice of the meeting and the accounts. Difficulties, such as attempts by attenders to use AGMs for self promotion, are in my view of far less concern than members' not having access to these minutes prior to their lodging proxy votes.

24. Whilst such developments would be welcome, the AGM is not, in my view, an appropriate forum for discussion of technical detail. In any case, the AGM occurs well after the year-end and after the accounts have been approved. A better solution to more involvement of members would be the establishment of the equivalent of a shareholder committee chaired by a Board member (such as supported by UKSA), with a right, inter alia, to question the auditors? A copy of UKSA's summary paper on this proposal is attached to this submission. I have mentioned this suggestion to both the Board and the auditors, but so far there has been no reaction.

Response to questions posed by the call for evidence

25. The questions posed by the call for evidence suggest that the effectiveness of external audit services can be improved by such factors as:- increased competition, better audit committee arrangements, separation of consultancy from pure audit services, increased dialogue with regulators, and even changing the role of auditors. Whilst all of these could have some effect, the single most important element in my view is, with respect, missing from this list of suggestions. That is to make more effective the *role of members* in the appointment, work and output of external audit services.

26. After all, *who* is the client in question 9 ? Is the Board, which is the legal representative of the audited entity, the client of the audit firm? This is seemingly implied by that question? So often that is the case in reality. Whereas, it is usually the activities of the *Board* that the *members* (to whom the auditors are supposed to report) want independent opinions about!

27. And is the Board otherwise accountable to members? At a Building Society, whilst the Board is theoretically appointed by the members, long gone are the days when members were presented with alternative candidates to choose from, for election - with curriculum vitae and a personal statement. At WBBS, for example, non-executive positions are routinely filled via the casual vacancy provisions, after vetting by the FSA. Accountability of the Board to members is in practice severely limited, as it would appear to have been the case at two of the UK's major banks.

28. So I suggest that the committee should give some thought to how the role of members of all large organisations, and particularly *the private investor* (see below), can be enhanced in relation to audit services. In that way we may be able to return, in some measure, to the relationships between members, the Board and the auditors, which became the cornerstone of our successful limited liability capital structures.

29. As regards members' input, a distinction needs to be made here between the interests and perspectives of institutional members and non-institutional members (private

investors). At WBBS, the PIBS changes affected non-institutional PIBS holders directly (their income and their personal capital wealth). Hence, such investors were inclined to protest, and indeed protested volubly at, what they perceived as unfair treatment in the capital restructuring, especially when they were not consulted and were usually unable to vote at the PIBS holders' meeting (because of holdings via pooled ISA and SIPP accounts).

30. The perspective of institutional PIBS holders was different, because they are an intermediary, managing other people's money. WBBS PIBS would undoubtedly represent a very small proportion of funds under management. Displaying a more passive reaction to the changes, they were more inclined to accept the changes without undue protest. No doubt many institutional PIBS holders concluded, understandably, that they would not be acting in the best interests of their investors if they devoted disproportionate resource to this problem, when that resource might be better employed on potentially more fruitful activities on behalf of their investors.

24 September 2010

Annexes

WBBS accounts for years ending 31 March 2009 and 2010 (re para 6) (not republished here)
UKSA summary paper on shareholder committees (re para 24) (not republished here)

Memorandum by the Office of Fair Trading

SUMMARY

1. This submission is made by the Office of Fair Trading (OFT), the UK's consumer and competition authority, whose mission is to make markets work well for consumers.

2. The OFT has been keeping the market for external audit services[25] in the UK under review since November 2002.[26]

3. The OFT considers that competition in the market for audit services in the UK may be limited. Some aspects of the audit market giving rise to this concern include companies' lack of clear incentive to switch auditors; the focus on established reputation in companies' choice of auditor; high switching costs; the established competitive advantage of the 'Big Four'[27] over mid-tier auditors[28]; the limited choice of auditors to appoint; and the difficulties mid-tier firms face in raising funds to finance expansion.

[25] Please note that throughout this document 'audit' refers to external audit only.
[26] See http://www.oft.gov.uk/shared_oft/press_release_attachments/accountancy.pdf
[27] The 'Big Four' auditors are PricewaterhouseCoopers, KPMG, Deloitte and Ernst & Young.
[28] Mid-tier auditors include companies such as BDO and Grant Thornton.

4. The OFT considers that these aspects of the audit market may explain low levels of switching of audit contracts; very high market concentration, with high and stable market shares for the Big Four being maintained at least as far back as 2002; and potentially high fees. The OFT also notes that there are significant concerns about the systemic risk arising from the potential impact of an audit firm failing.

5. Audits enable stakeholders such as investors, lenders and trading partners to assess the reliability of a company's financial statements. If this is not done effectively, they may be deterred from doing business with that company, in which case companies would be likely to face less favourable terms of trade, including higher costs of obtaining finance.

6. Higher audit fees or higher financing costs are likely to feed through to higher prices for consumers. Weak competition may also contribute to a risk of wider, systemic failure in the audit market. Moreover, barriers to expansion might make it difficult for mid-tier firms to step up to replace one of the Big Four firms if it were to exit the market unexpectedly.

7. Given that competition may be limited, there are a number of changes that may have the potential to increase competition in the market. OFT's preference would be for changes to be delivered through the market. Market-led solutions ultimately result in the right incentives being harnessed so as to deliver the best outcomes for consumers. However, certain improvements may also be sought through regulatory or legislative change, at least in the short term. The nature of the audit market is such that changes may have to be international to be successful.

INTRODUCTION

The Office of Fair Trading

8. The OFT is the UK's consumer and competition authority. The OFT's aim is to make markets work well for consumers. It performs this role by deploying a variety of tools at its disposal including the enforcement of consumer and competition laws and advice to policy makers where wider government policies affect competition and markets.

OFT's previous and current work on the audit market

9. In 2002, the OFT considered whether a market investigation or Competition Commission referral would be appropriate for addressing competition concerns following the Enron affair and subsequent collapse of the audit firm Arthur Andersen. In November 2002, the OFT stated:

'There is public concern about the increased concentration in the supply of audit and accountancy services, and its implications for competition and choice. The OFT recognises that concern. But [...] we do not, at this stage, propose to launch a full-scale investigation into the sector, or to refer it for investigation by the Competition Commission. [...] Rather, our approach is to keep the market under review and to examine any competition implications of regulatory proposals that may arise from current reviews of audit and accountancy services.'[29]

10. Since then, the OFT has provided advice to Government on the implications for competition in the audit market of proposals to permit auditors to limit their liability by way of negotiated caps[30] and contributed to the UK's submission to the OECD roundtable on competition and regulation in auditing and related professions in June 2009.[31] In addition, the OFT has, since 2002, liaised, and will continue to liaise, with the Department for Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) in relation to concerns regarding this market.

11. A recent report by the FRC indicated that a number of recommendations intended to result in the audit market working more efficiently and to increase audit choice in the UK had been implemented but had been largely unsuccessful. The FRC found that 'there is limited evidence that the recommendations have had a significant impact on market concentration and the risks arising from that concentration'.[32]

12. In addition, in preparing this submission, we have met with four of the largest providers of audit services (BDO, PwC, Deloitte, and Grant Thornton), providing them with an opportunity to tell us their views and experiences of the market for auditors.[33] However we have not shared this document with them.

13. Further details of the OFT's ongoing work can be found on our website.[34]

THE MARKET

14. This submission addresses the concern that competition in the audit market may be limited and may deteriorate in the future. Therefore, it relates primarily to three questions posed in the call for evidence from the Select Committee on Economic Affairs:

[29] See http://www.oft.gov.uk/shared_oft/press_release_attachments/accountancy.pdf
[30] See http://www.oft.gov.uk/shared_oft/reports/financial_products/oft741.pdf
[31] See http://www.ftc.gov/bc/international/docs/competitionaccount.pdf
[32] *Choice in the UK Audit Market: Fifth Progress Report* (June 2010). See: http://www.frc.org.uk/publications/pub2289.html.
[33] The invitation to meet was extended also to KPMG and Ernst and Young.
[34] See: http://www.oft.gov.uk/OFTwork/markets-work

Q1: Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?
Q2: Does a lack of competition mean clients are charged excessive fees?

Q11: Should more competition be introduced into auditing? If so, how?

15. In addressing these questions in particular, the remainder of this submission is presented in the following three sections:
    - aspects of the audit market that may adversely affect competition;
    - effects observable in the market; and
    - key questions about possible changes to the market.

Relevant market

16. For the purpose of this submission, the relevant market is the provision of external audit services to large companies. This may be taken to mean FTSE350 companies. However, there may be separate markets defined more narrowly than this, for example by reference to FTSE100 companies and/or according to particular sectors that have more complex audit requirements, such as banking and insurance.

ASPECTS OF THE AUDIT MARKET THAT MAY ADVERSELY AFFECT COMPETITION

17. The OFT considers that competition may be limited as a result of the following six aspects of the audit market:

    - **There is little incentive for companies to switch auditor.** Audit fees may not drive auditor selection and switching because they are small in comparison with the level of companies' finances. In addition, the difficulty of discerning audit quality and the tight regulation of how audits are conducted may mean that little difference between the audits of different suppliers is apparent, so that it is difficult for Finance Directors and audit committees to distinguish between the audit offerings of different suppliers.[35] Where the scope for differentiation in service quality is perceived to be limited, companies may view audit simply as a regulatory hurdle, rather than as a service that is capable of adding value.

    - **In choosing an auditor, companies focus on established reputation, which imposes a barrier to entry to non-Big Four auditors.** Given the difficulty of differentiating quality, companies may select auditors on the basis of existing reputation, calculating that this will avoid risk and the need to consult investors,

[35] Source: survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also stakeholder comments and FRC (Market Participants Group) and academic papers.

rather than on the basis of maximising the value added by the audit. There seems to be little difference in reputation between the Big Four, but a larger difference between the Big Four and mid-tier firms. As a result, mid-tier auditors may struggle to compete even on the basis of a better value or quality proposition.[36]

- **It is very costly for companies to switch auditor.** Substantial management and audit committee time is required to put an audit out to tender and select a new auditor; it takes time for a new auditor to gain an understanding of the business in order to audit it, during which time the company management will have to invest time in bringing the auditor up to speed; and there is a higher risk of a new auditor making mistakes initially.[37]

- **Larger auditors possess certain attributes necessary for auditing large companies.** These attributes are difficult to acquire so may constitute a barrier to entry. These include an extensive, integrated international network; relevant industry specialisation; greater experience in auditing complex businesses; a greater ability to offer additional services (audit may be used as a gateway to providing these services and larger audit firms may have an ability to provide a more attractive and complete range of services than smaller audit firms); existing links with Finance Directors and audit committee chairmen; and possibly an ability to recruit higher calibre staff attracted by the audit firm's reputation. It seems that it is difficult for smaller auditors to develop the necessary attributes, such as reputation, expertise and resources, to undertake large audits because of the difficulty of securing large audit contracts in the first place – potentially a vicious circle.[38]

- **Companies may have a limited choice of auditors that they can appoint.** Companies may require an auditor with a particular technical capacity, such as a particularly large international network or a specific industry specialism, which may favour the Big Four. Choice may also be restricted by regulation, such as the USA's Sarbannes-Oxley Act of 2002, which limits the ability of public reporting companies to appoint as their auditors firms who supply them with certain types of non-audit services. Further, choice may be limited by commercial considerations, for example companies not wanting to employ auditors that work closely with competitors. This leaves some companies with a very limited choice of their current auditor and only

[36] Source: comments of institutional investors and survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, FRC (Market Participants Group) and academic papers.
[37] Source: Interviews and survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, stakeholder comments and FRC (Market Participants Group) consultation responses.
[38] Source: Interviews with large-scale companies and survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also stakeholder comments and FRC (Market Participants Group) paper.

one or two others.[39]

- **There are barriers to smaller auditors raising sufficient capital to grow.** The OFT understands that substantial investment would be required for mid-tier auditors to gain a significant foothold in the market for audit services provided to FTSE250 companies and that this may very well exceed the potential returns, with significant risks and a long payback period. Further, avenues for raising capital are limited by the requirement for a firm to be majority-controlled[40] by qualified auditors[41] and by their partnership structure, as investment may not be attractive to older partners due to the limit that retirement imposes on the period in which they can receive a return on investment.[42]

EFFECTS OBSERVABLE IN THE MARKET

18. The OFT considers that the aspects described above could result in the following three potential market effects:

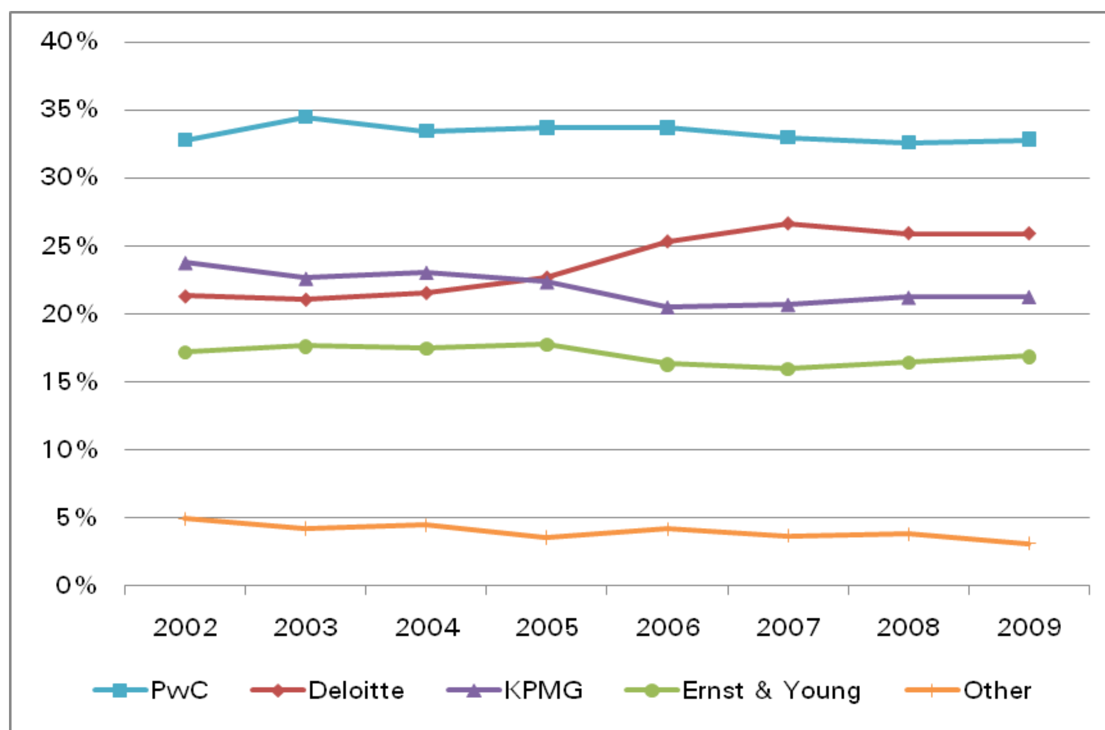
- **Low levels of tendering and switching:** Tendering does not appear to occur very often. One of the Big Four cited in Oxera's 2006 report was aware of only 28 FTSE100 companies that had held competitive tenders in the previous 15 years.[43] Other evidence demonstrates that between 2001 and 2009 average switching rates were less than four per cent annually.[44]

- **High concentration:** In 2009 the Big Four earned all audit fees (that is 100 per cent) levied for FTSE100 companies and 98 per cent for FTSE250 companies, with PwC alone earning 47 per cent of FTSE100 companies' audit fees.[45] Concentration is higher in some specific industry sectors including mining and quarrying; hotels and restaurants; and electricity, gas and water supply.[46] The combination of high market

[39] Source: Survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, stakeholder comments and FRC (Market Participants Group) paper.
[40] This relates to the exercise of control according to voting rights and by the firm's management board.
[41] The legal rules relating to the control of audit firms are contained in the Audit regulations, pursuant to the requirements of Part 2 of Schedule 10 of the Companies Act 2006. These requirements flow from Article 3 of Directive 2006/43/EC on statutory audits.
[42] Source: modelling of prospects for entry by mid-tier firms and observations in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, FRC (Market Participants Group) paper and comments by stakeholders.
[43] Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC, p.43.
[44] OFT analysis shows that rates were 1.7 per cent annually for FTSE100 firms and 3.3 per cent annually for FTSE250 firms (this analysis covers firms that are still in the FTSE350 currently).
[45] These figures are calculated according to audit fees levied for current FTSE100 / FTSE250 companies only. When concentration is measured using the Herfindahl-Hirschman Index (HHI), the figure for the FTSE 100 is 3,175, while the figure for the FTSE 250 is 2,772. A HHI figure in excess of 1800 for a market is typically considered to represent a highly concentrated market.
[46] Two of the Big Four supplied more than 80 per cent of audit services in wholesale and retail trade; mining and quarrying; hotels and restaurants; and electricity, gas and water supply.

concentration and low rates of tendering and switching gives rise to a stable market with limited opportunities for rivalry and few changes in market shares over time. This can be seen in the following graph of shares of supply of audits for FTSE 350 companies between 2002 and 2009.

Table 1: Shares of supply for audits of the FTSE 350 companies (by number of clients)



- **High fees:** Some evidence has been found of a link between concentration and fees and also that audit fees for clients of the Big Four appear higher than for companies using mid-tier auditors, all other things being equal.[47]

19. The OFT considers, therefore, that weak competition in this market may mean that audits cost companies more than is necessary, with the possibility that the market does not operate as efficiently as possible and that the value added by audits is not maximised.

20. Audits enable stakeholders such as investors, lenders and trading partners to assess the reliability of a company's financial statements. If this is not done effectively, they may be deterred from doing business with that company, in which case companies would be likely to face less favourable terms of trade, including higher costs of obtaining finance. Higher audit fees and higher financing costs are likely to feed through to higher prices for consumers.

[47] Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC.

SYSTEMIC EFFECTS

21. The limited choice of auditors and high barriers to expansion for mid-tier audit firms mean that if one of the Big Four were to exit the market, existing competition problems in the market could be exacerbated. There might also be a short-term risk of some companies being unable to purchase audit services, leading to a loss of confidence in the financial status of high-risk companies and possibly among investors more generally. Thus the existing high barriers to entry, leading to high market concentration, can be seen as contributing to the identified risk of wider, systemic failure in this market. Moreover, barriers to expansion might make it difficult for mid-tier firms to step up to replace one of the Big Four firms if it were to exit the market unexpectedly.

KEY QUESTIONS ABOUT POSSIBLE CHANGES TO THE MARKET

22. If indeed competition in the audit market is limited, there are a number of issues to consider before determining what changes to the market could lead to the most effective outcome. These considerations cover regulatory change, changes in ownership arrangements and planning for the possible failure of one of the Big Four.

23. We make two key observations in relation to these issues. Firstly, the OFT's preference would be for changes to be delivered through the market. The OFT considers that market-led[48] solutions ultimately result in the right incentives being harnessed so as to deliver the best outcomes for consumers. However, the OFT recognises that certain improvements may also be sought through regulatory or legislative change, at least in the short term. Secondly, we recognise that many of the potential solutions will require action on an international level if they are to be wholly effective.

24. The issues to consider in relation to different types of possible changes to the market are discussed below.

25. Under the broad heading of regulation of the audit market, the OFT has considered a number of specific changes that could be contemplated, such as:

- **Changes to the minimum requirements of the statutory audit[49].** We consider that it is worth exploring whether the level of detail, scope[50] or

[48] Market-led solutions are those which can be delivered by the firms within or the customers of a market, perhaps through voluntary initiatives to increase transparency. market-based solutions are solutions which are based on making the market itself function more effectively, as opposed to regulatory solutions.

[49] 'Statutory audit' refers to the functions and duties of a company's auditor in reviewing and reporting on a company's annual accounts, directors' report and directors' remuneration report as required by UK company law. See Part 16 of the Companies Act 2006.

materiality[51] required of statutory audits should be reduced. Companies could then choose whatever methods (in addition to the statutory audit) were necessary to enable them, investors and any other bodies using the accounts (for example companies wishing to trade with them) to assess the company's financial position with the level of confidence that is appropriate for their particular purposes. Thus they might, for example, commission audit firms or consultancies to provide a more thorough audit or whatever assessments of particular aspects of their operations, for example the performance of particular assets, divisions or products were thought necessary.

As well as potentially reducing the burden on companies, reducing the requirements of statutory audit might stimulate switching to smaller auditors that are able to undertake a more limited audit. Doing this might also reduce auditor liability for errors and hence auditors' risk of failure. Despite evident risks around such a change, the OFT considers that these must be balanced against the compelling possible gains that would result from shifting the requirements and incentives of companies when selecting auditors. Such a regulatory change could result in companies being more motivated to ensure that the potential value added by audits is maximised.

- **Reducing differences in the approach and standard of audits in different countries**. Ensuring that auditors who approve accounts in one country are able to do so in other countries could increase the ability of mid-tier firms to win contracts to audit international companies (if not on their own then possibly in combination with other firms). This might also facilitate companies employing different auditors in different countries since the likelihood of time-consuming disagreements on how to consolidate accounting results might be reduced. Increasing standardisation and harmonisation might assist in reducing concerns, whether based on fact or simply perception, regarding the ability of mid-tier firms to handle audits of international companies.

- **Changes to the rules covering the use of audit firms.** There are a number of possibilities for changes in this area, including a requirement for a company to have two auditors (either through a split or joint audit process) and the mandatory regular tendering of audit contracts. In addition, a requirement for outgoing auditors to provide information to incoming auditors in a standard format would address concerns around the time and investment by company management that is required for a new auditor to understand the business and the greater risk of mistakes being made in this initial period. The aim of such measures would be to

[50] i.e. coverage.

[51] This relates to the size of error that would be required to change the view of someone reading the accounts as to whether they are 'true and fair'.

strengthen rivalry in the market by increasing the incentives and ability of companies to switch between auditors and reducing the costs of doing so.

26. Another issue to consider is whether some form of change in the rules governing the ownership arrangements of audit firms might be beneficial. Audit firms currently have to be majority controlled by auditors which limits the scope for new investment and hence expansion of mid-tier firms.

27. In the event that less interventionist changes are not successful in bringing about an increase in competition and a reduction in systemic risk in the market, attention might turn to whether direct intervention is called for in order to shift the market to a new equilibrium. However, it is necessary in all such cases to ensure that any such response is at most targeted 'micro-surgery' rather than potentially more drastic intervention in order to avoid the risk of undermining competition in the long run.

28. In addition to the issues to address before determining what interventions should be used to achieve the most effective market outcome, it may also be appropriate to focus attention on what could be done to mitigate harm if any of the Big Four firms were to leave the market. In this regard, the OFT is considering undertaking further research and analysis vis-à-vis potential competition issues in concentrated markets where there may be a risk of systemic failure, where any such failure could cause significant harm to the UK economy. Our interest in such markets is distinct from other regulators who do not have a competition focus. Our interest is not on assessing the level of systemic risk as such but in assessing whether such markets currently deliver what consumers want on competitive terms that present good value to consumers and, more broadly, to the wider economy. Any such work, if undertaken, would likely consider what, if any, appropriate solutions may be available.

CONCLUSION

29. This submission has explained that the OFT considers that competition in the market for audit services in the UK may be limited. It has presented a number of issues to be considered in determining appropriate changes to the market that could increase competition in the market and thereby possibly reduce the systemic risk of failure of one of any of the Big Four, with the resulting significant impact of this on companies and consumers.

24 September 2010

Letter from Mr Bob Pigeon

You ask for evidence to your Select Committee upon the role of Auditors. I am a 65 year-old Chartered Accountant, trained as an Auditor but spending most of my career in Industry.
Coincidentally I have just written to my MP, Mark Hunter as follows: -

"The Government is proposing to close down the Audit Commission and pass its work to Accounting Firms. They must be salivating. I attach a copy of the lead from this month's Accountancy magazine. Are these safe hands into which to pass this work? (Not reprinted here)

I give you another alternative: -
1) Transfer all Company Audits to a beefed up HMRC
2) Obviously HMRC look at these companies anyway. This change would allow them to do much more detailed checks, which has to improve the tax take.
3) Then give HMRC the responsibility of auditing Public Bodies as well

I reckon that Points (1) & (2) should save £2.9 Billion annually as per the attached (Appendix 1) calculation and you should save 75% more out of the Audit Commission transfer.

Of course fellow members of my Institute will cry Blue (or Orange) Murder but they do not deserve any less. I personally have been ashamed of the recent Audit failures particularly Enron. Audit reports have been diluted so much from my early days of a "True and Fair View" that actually meant something. This proposal will put a lot of my fellow members out of work but in the medium term that will be to the benefit of UK PLC because so much talent goes into the Accounting profession, which could be more productively used elsewhere. Last time I looked the proportion of Engineering and Chemistry Graduates going into my profession was ridiculous. Admittedly that was some time ago.
The General Public would welcome such a move almost as much as the Bankers getting their comeuppance!

Please GET VINCE CABLE TO TELL ME WHY THIS WOULD NOT WORK or preferably IMPLEMENT IT."

For the sake of completeness, I attach the leader from this month's Accountancy, which you may well have seen and my calculations.

Reverting to the questions asked, I would reply as follows: -

1. *Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?* Partly yes but perhaps more importantly if you do not have one of the big four as the Group FD you are putting your neck on the block. Taking one of them is the easy option. Any other course would have to be heavily justified. Also nearly 50 years ago I did my Articles for a firm called Cooper and Cooper, now Cooper Adamson. Prior to the first World War that company was actually one of the big ten because it ran Rubber Settlement House when Rubber was king. The firm had dwindled as Rubber dwindled but still held onto a few big Audits including EMI. I think we did a pretty good job but Cooper

Brothers as they were then, now PWC, found it easy pickings to persuade the Board that we should be replaced by them. When they focus their power and influence, a small audit firm has no chance. Certainly in those days it would have been the attraction of their other specialities such as Tax that would have influenced the decision.

2. *Does a lack of competition mean clients are charged excessive fees?* Probably not. Any FD worth his salt will have held a beauty parade at least once every 5 years

3. *Does a narrow field of competition affect objectivity of advice provided?* A good FD will run rings round the Auditors because he knows the business and they can only scratch the surface. Is he likely to be open to advice? If he wants advice he will have got it from one source or another before the audit. If, as is likely he has got it from his auditors on a particularly sticky point, they are not going to exactly query it as can be seen from the disastrous green light given to the Banks' off balance sheet items that would not have been acceptable to an American Auditor. So it is not the "narrow field of competition" but other issues that turns the audit into largely a rubber stamping exercise. Only when a company is in real demonstrable trouble will the balance of power move from the FD to the Auditor

4. *Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?* See 3. Limited competition is irrelevant

5. *What is the role of auditors and should it be changed?* You will see from my letter my personal sadness at the way the audit has diminished. It HAS to be changed and I like to think that I have given you a rather clever alternative.

6. *Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008?* Absolutely not but it would have needed a very strong man to stand up against the perception of what was acceptable however erroneous. "The Emperor's new clothes" surely is an apt description of events except that we did not even have the small boy to point out that "the King is in the altogether...". But then what is new? Enron when you look at it in any detail was much worse. There was a "small boy" crying foul and everybody laughed at her and she was fired for her trouble if I remeber correctly. More importantly the way that dubious profits were manufactured and all taken up front could never be justified to even a first year articled clerk. I was and remain disgusted at the antics of the Auditors shredding the records of their incompetence after trying to justify their actions on the Today programme. Get a transcript of that interview. I am sure that it is relevant evidence. I was and remain disgusted that a once well respected English Chartered Accountant was a member of the Audit Committee.

   If not, was the lack of competition in auditing a contributory factor? Lack of competition has nothing to do with it. The relationship is just too cosy.

7. *What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?* Go back to earlier failures. Usually you find that either the CEO and most of the Board either know that there is something badly wrong and are doing a cover up job or they really do not understand what is going on in their own business but "Trust" their underlings. In either of those

circumstances you have to have an extremely cynical, very objective and highly experienced team of auditors to pick it up. Or do you? If the underlying principle of every thing was KISS (Keep It Simple Stupid) and if it was not explicable to the uninitiated then it was not acceptable, then surely we would all be a lot happier. For example, why do they need off balance sheet transactions? Because the Company is up to no good either to avoid tax, regulation, its auditors or its shareholders. It takes a brave man to say I do not understand and I am not signing off your accounts until I do. So Auditors, regulation and Tax all need to go hand in hand. Again I have given you a potential solution, which actually will save money.

8. *How much information should bank auditors share with the supervisory authorities and vice versa?* Everything of course.

9. *If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?* Whilst Auditors are in thrall to the Board they will never be strong enough.

10. *Do conflicts of interest arise between audit and consultancy roles?* Of course
If so, how should they be avoided or mitigated? See my e-mail to Mark Hunter. (Not printed here)

11. *Should more competition be introduced into auditing? If so, how?* By taking it out of the hands of the current Auditors.

12. *Should the role of internal auditors be enhanced and how should they interact with external auditors?* How is somebody paid by the Company going to comfortably rat on it to the Auditors? Occasionally perhaps but very seldom. It is a "red herring"

13. *Should the role of audit committees be enhanced?* I do not see that you can enhance it whilst the whole operation is so cosy. The answers to question (6) & (7) are relevant. Like Internal Auditors, it is a useful tool but when the going gets rough it will either be swamped or totally ineffectual. There is no alternative but to make Auditors entirely independent of the Board and to give them real teeth allowing them to be "red in tooth and claw".

14. *Is the auditing profession well placed to promote improvement in corporate governance?* No way. Radical change is needed and they have 100% vested interest in avoiding that.

I hope that helps you. I am sure that you appreciate that at 65 I find it very sad that I should be so dismissive of so much of my profession. I could be equally critical of the legal profession. Of course the largest impediment that will be put in your way in the unlikely event that you choose to support my proposal is that any change has to be done Internationally to avoid undermining our competitive position as a Financial centre. Sadly there is merit in that argument but you will never have a better opportunity of persuading the Americans to go along a similar course. Job Done.

September 2010

Appendix 1

Theoretical Savings from HMRC taking over Company Audits

				24th August 2010		
				£ Million		
1	Audit Fees for the Footsie 350	2005		897		
	Source	http://images.vnunet.com/bif_static/pdf/FD_jan05_auditfees.pdf				
	Inflate by	10%		89.7		
				986.7		
2	Estimated Hours at	£200	per hour	4,933,500		
3	HMRC Cost	£60,000	p.a.			
	for an average employee					
	Chargeable time			£/hour		
	200 days @	6	hours	50		
						£ Million
4	"Profit"					740
5	2010 Corporation Tax			£ Billion		
	per Office for Budget Responsibility			43		
6	Closer scrutiny has to increase this take by at least					
					5%	2,150
						2,890

Notes

a) Assume legislation fixes Audit fees at there 2010 % of turnover

b) Inspector's Time would have already been spent on the Tax Review

c) HMRC take no longer to do the work than private firms.
Indeed they would employ 4,111 Accountants direct from the profession just for this task.
This also removes the oft repeated complaint that there are not enough Accountants monitoring Government spending

d) Appoint a Senior Accountant from Industry not the profession to implement this

e) The biggest problem will be International acceptance but why should not the USA take up the idea too?!

Memorandum by PricewaterhouseCoopers

1. Auditors make an important contribution to the economic health of the nation through the role they play in corporate governance and the functioning of the capital markets by providing independent assurance on the financial statements of companies. Furthermore, the largest audit firms are important employers and developers of talent in their own right. However, we recognise that, in the aftermath of the recent financial crisis, stakeholders and policy makers are questioning whether auditors could make a greater contribution to the strength of the capital markets. The Committee's inquiry will be an important contribution to this debate.

2. In developing our evidence, we have reviewed the questions set out in the Committee's "Call For Evidence" and have concluded that they can be summarised as addressing the following broad topics:

   - The impact of concentration in the audit market (questions 1, 2, 3, 4 and 11)
   - The role of the auditor during the financial crisis and potential areas for future development (questions 5, 6, 7, 8 and 9)
   - The potential for conflicts of interest between audit and consultancy roles in multi-disciplinary firms (question 10)
   - The relationship between sound corporate governance and the external audit function (questions 12, 13 and 14).

   We address each of these issues below.

3. The issues addressed in this inquiry are complex and we note that many of the topics set out above are already the subject of detailed consultations in the UK and elsewhere. We will be responding to each of these consultations, where appropriate in conjunction with other firms in our global network. In particular, we believe it is important for any legislative action taken by the UK government or regulators to recognise the key requirement for the UK to remain competitive in a global environment.

4. We would be happy to provide further information in support of our evidence and to provide oral evidence at subsequent hearings if the Committee would find this helpful.

Summary of our views

5. We believe that the audit market is an effective and competitive market. Since 2002, the auditing profession has made a significant number of changes to improve audit quality and to provide greater transparency around their own internal governance, partly in response to the recommendations by the FRC's Market Participants Group in 2007[52]. Some of these recommendations have only just been implemented and it is therefore too early to assess whether they have been effective in implementing both supply-side and

[52] http://www.frc.org.uk/documents/pagemanager/frc/FRCMPG%20Final%20Report%20for%20web.pdf

demand-side measures to increase confidence in the profession. We believe that these initiatives should be monitored and their impact assessed before any further action is taken.

6. More immediately, action could be taken to make the audit process more transparent through better communication of the dialogue between audit committees and external auditors; and through more regular dialogue with stakeholders and regulators. At the same time we would welcome a wider debate about corporate reporting, focusing on a more integrated model that provides a more coherent, and less complex, picture of a company's performance and exposure to risk. Any such debate should include a discussion of the role that independent assurance can play in enhancing public confidence in the reporting model.

The impact of concentration in the audit market

7. The introduction to the "Call for Evidence" states that "audit is dominated globally by the Big Four". This situation was created primarily by a process of consolidation during the latter part of the 20th century which reflected the needs of capital markets in both geographical spread and complexity, leading to the creation of five large global networks in 1998, subsequently reduced to four with the demise of Arthur Andersen. These mergers arose in response to market demands for audit firms with the necessary networks, people, methodologies and reputation to deliver quality audits for the largest multinational corporations.

8. In the context of the UK audit market, the concentration of audit appointments on the four largest firms is only true for the audits of companies listed on the main board of the London Stock Exchange. Below this level there is a wider range of firms supplying audits. For example, in February 2010 56.6% of the audit of companies quoted on the Alternative Investment Market (AIM) were audited by firms other than the largest four firms[53]. For this sector and for unlisted companies, the audit market remains highly fragmented.

9. The European Commission[54] acknowledged the importance of size when it determined that:

    "audit and accounting services to quoted and large companies form part of a separate product market: the necessity for such companies to have audit and accounting services provided by a firm with the necessary reputation in the financial markets (in the case of quoted companies), the geographic breadth to cover the companies' needs worldwide (in the case of multinationals), the depth of expertise in the particular sector (large companies in general and, in particular, regulated sectors such as banking and insurance) and significant resources (all large companies)… All these features are only provided by one of the large global audit and accounting networks".

10. The relationship between audit quality and the relative size of the audit firm is acknowledged by the Audit Inspection Unit of the Financial Reporting Council[55] which stated that:

[53] Fifth report of the Financial Reporting Council on Choice in the Audit Market, June 2010.
[54] Case No COMP/M.2810 – Deloitte & Touche/Andersen UK, Merger Procedure Article 6(1)(b) Decision, Commission of the European Communities, 1 July 2002.
[55] AIU 2009/10 Annual Report, 21 July 2010

"The AIU continues to find that a higher proportion of audits conducted by smaller firms require significant improvement."

11. We are aware that some commentators are concerned that the practical restriction, at least in the short term, of a segment of the audit [and accounting] services market to four rival suppliers, may mean that the intensity of competition is reduced; and that, if this was indeed the case, it might result in outcomes inferior to those that would be expected in an effectively competitive market – lower efficiency, higher prices, less innovation and reduced quality.

12. We believe that these concerns are without foundation. There is intense competition between the four largest audit firms to win and retain the audits of large companies and these appointments are subject to independent governance. Such competition ensures that PwC and its competitors have every incentive to offer the quality global audits demanded by the large corporate clients, to be efficient and innovative, and to pass on the benefits to clients through the lowest possible prices. Delivering value to our clients whilst ensuring we do not compromise on the quality of our audits is the key priority of our own assurance business.

13. Critically, the reason why having four large firms competing for the supply of audits to the largest UK companies is sufficient to engender fierce competition is that the UK audit market is a "bidding" market. When choosing an auditor, large companies use a competitive tender process. It is recognised by economists and competition authorities that bidding markets have different characteristics from other markets, leading to intense competition even where there are relatively few suppliers.

14. In its investigations of the audit market when considering the merger of Deloitte & Touche and Andersen (UK)[56], and earlier the merger of Price Waterhouse and Coopers & Lybrand[57], the European Commission acknowledged the bidding nature of the audit market and how this imposed competitive constraints on the audit firms. In particular, it noted that: *"launching an invitation to tenders imposes a competitive constraint on the incumbent auditor, often leading to a re-negotiation of the fees"* and that *"any of the Big Five could possibly win or loose (sic) a competitive tender, without any clear link towards its existing market shares"*.[58]

15. Because of the expense involved in the tendering process itself, as well as the dislocation, cost and quality risk involved in bringing in a new auditor, large companies do not choose to put their audit out to tender very frequently. There are other mechanisms for companies to ensure price competitiveness. For example, we are aware of situations where clients have used the statutory requirement for auditors to be reappointed annually as a tool in negotiations over the level of fees.

16. Furthermore, since the typical length of an auditor-client relationship can extend over many years, the incumbent auditor is aware that its competitors would make a serious investment in attempting to win over its client for what would be likely to be a long-term relationship. Competitive pressures are thus brought to bear on auditors, without the need for frequent costly tender processes which would themselves raise the costs of both the audit firms and their clients, without necessarily improving the quality of the audits provided.

[56] See 1 above
[57] Case IV/M.1016 – Price Waterhouse/Coopers & Lybrand, Commission Decision of 20 May 1998.
[58] Deloitte & Touche/Andersen UK, see footnote 1.

17. That there has been no new entry since the five large firms became four is itself indicative that competition in the market is working successfully for the large company audit clients, and that the market is not sufficiently attractive to other potential suppliers of large audits in terms of the investment-risk-reward payoff to encourage investment. This is an indication that the market is working effectively, and that prices are not excessive in relation to the costs and risk of supply.

18. This pressure on prices leads to a need to ensure efficiency in the provision of audits. This in turn has to be balanced with the regulatory focus on the continuous improvement in audit quality. This was recognised in the AIU's 2010 public report on PwC[59] which stated:

    "The firm's strategy includes quality as one of its main priorities. The leadership of the firm and audit practice continues to focus on initiatives to improve or maintain audit quality, whilst also aiming to achieve efficiencies on audits. Although there is no evidence to suggest that this has detracted from the focus on audit quality, continued care is needed to ensure the emphasis on efficiency does not adversely affect audit quality."

19. Following the collapse of Arthur Andersen in 2002, there have been a number of significant regulatory initiatives to improve the quality of audits, including the independent monitoring of auditors of public interest entities by the AIU and the development of rigorous ethical standards to ensure that auditors remain objective in their relationships with their clients. Further regulatory initiatives have addressed the need to provide additional transparency around the governance of audit firms, culminating in the adoption in the UK of an audit firm governance code[60] which incorporates the appointment of independent non-executives by the eight largest audit firms.

20. These initiatives are relatively new and it is too early to demonstrate how effective they are in developing market confidence in, and thus enhancing the competitiveness of, the next tier of audit firms. We believe that it would be helpful to monitor the implementation of these initiatives and to assess their impact before any further action is taken.

The role of the auditor during the financial crisis and potential areas for future development

21. Following the financial crisis, all participants in the capital markets have a responsibility to reflect on the causes of the crisis and to examine the potential for changes in the way the markets operate in future. In this context, the role of the auditors was addressed by the House of Commons Treasury Select Committee[61] which stated:

    "*We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is.*"

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[59] http://www.frc.org.uk/images/uploaded/documents/Public%20Report%202009-10%20PwC.pdf (section 2.2 page 9)
[60] http://www.frc.org.uk/documents/pagemanager/frc/The%20Audit%20Firm%20Governance%20Code.pdf.pdf
[61] http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf (para. 221 page 77)

22. In response to this challenge, we are taking steps towards changing the role and responsibilities of auditors. [For example, we have committed to a closer working relationship with the banking supervisors and are actively participating in a number of other initiatives in conjunction with the FRC and the UK professional accounting bodies].

23. More recently, there has been a suggestion by the FSA and FRC in a joint discussion paper[62] that auditors may have been insufficiently sceptical in their audits of banks in the run-up to the crisis. We do not accept this assertion.

24. Professional scepticism is fundamental to what auditors do. It is defined in auditing standards[63] as "*an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.*" Whilst practical application of this requirement is judgemental and will vary according to circumstance, it is hard to evidence. Scepticism is inevitably applied in real time and is a cultural and behavioural issue. To reinforce the culture of scepticism, we have a robust system of internal quality control reviews and consultation procedures. We believe that this is working. It is our experience that, in the vast majority of cases, audits give rise to changes in the financial statements prior to issuance.

25. It is the job of the auditor, as established by internationally agreed auditing standards, to challenge management's assertions and ensure that they are backed with evidence that is appropriate, supportable and capable of independent verification. It is not the auditor's job to develop alternative views and then try to persuade management to adopt them in preference to theirs.

26. As indicated above, however, the recent financial crisis has raised questions about the role of the auditor, particularly in the context of the audit of banks. We are already taking steps to address these questions. In the context of banks, we recognise that more regular bilateral and trilateral meetings with the supervisors of our audit clients will enhance both the supervisory and audit processes by encouraging greater dialogue and information sharing by all parties. We were active participants in the development of the proposals set out in the ICAEW Financial Services Faculty report[64] which also addressed the need for improved risk reporting by banks and the potential for increasing the level of assurance over these disclosures. We will continue to participate in developing more specific proposals in these areas in conjunction with other stakeholders.

27. More generally, we recognise that there is a need for significant improvements in corporate reporting and consequential changes in the role of the auditor. As a first step, we recognise that how auditors currently discharge their professional responsibilities is often opaque. To ensure investor confidence in company's financial statements we believe that it is essential that the audit process is made more transparent. One way to achieve this would be for audit committees to disclose more details about the dialogue between them and the external auditors. At the same time, there should be a wide-ranging public debate about the future of corporate reporting to identify ways in which the reporting model can be more integrated and less complex. This debate should include all stakeholders, including investors, government and regulators, and should incorporate a discussion of the role that independent assurance can play in enhancing public confidence in the reporting model.

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[62] Financial Services Authority & Financial Reporting Council Discussion Paper DP 10/3 "Enhancing the Auditor's Contribution to Prudential Regulation", June 2010

[63] International Statement of Auditing (ISA) 200, para 13(l).

[64] Institute of Chartered Accountants in England & Wales Financial Services Faculty "Audit of Banks: Lessons from the Crisis", June 2010.

The potential for conflicts of interest between audit and consultancy roles in multi-disciplinary firms

28. The UK audit profession has operated for many years largely through the medium of multi-disciplinary practices providing a range of taxation, advisory and consulting services in addition to assurance services. It is important to recognise, however, that the growth of these other services is not dependent on the provision of non-audit services to audit clients.

29. Where non-audit services are provided to audit clients, there is an effective principles-based ethics regime requiring the analysis of the threats to objectivity and the application of appropriate safeguards. This has worked effectively both in the UK and elsewhere in the world. This regime recognises that there are circumstances where no safeguard can be established, resulting in strict prohibitions.

30. The effectiveness of this regime, combined with the key oversight role played by audit committees in considering and determining the appropriateness of the appointment to provide non-audit services, has been an important factor in increasing the level of independent scrutiny and thus increasing confidence in the regime. It was notable that very few respondents to the October 2009 consultation on the topic by the Auditing Practices Board[65] identified significant concerns about the effectiveness of the current system.

31. An analysis of the annual reports of major listed companies indicates that there has been a significant reduction in the proportion of non-audit fees to audit fees in recent years. At the same time, audit firms have recorded significant growth in revenues from services to clients where they are not the auditor, illustrating that this growth has not been generated from their audit client base. Consequently, we do not believe that the continued growth of multi-disciplinary firms represents a conflict of interest with, or a threat to the objectivity of, the audit services provided by the same firms.

32. In contrast, we believe that the ability of auditors to operate within the framework of multi-disciplinary practices is important for the following reasons:

    a) A profitable growing firm is in a better position to invest in the continuous improvements in audit quality necessary to allow it to respond to the increasing demands of business, shareholders and regulators.

    b) The existence of a range of skills and breadth of experience within an audit firm allows for greater insight into market issues and can significantly augment audit quality, particularly in the audit of complex business transactions. This was acknowledged by the AIU in their 2009/10 Annual Report which stated[66]:

    - *"The increasing use of internal specialists, especially by the major firms, to evaluate valuations performed by client specialists and to assist in the audit of other complex audit areas such as taxation and pension balances contributes to improving the quality of audit evidence obtained in these areas."*

    c) Multi-disciplinary practices have a significantly enhanced ability to recruit and retain the highest quality professionals. A working environment where employees have the

[65] http://www.frc.org.uk/images/uploaded/documents/Consultation%20provision%20of%20non-audit%20services%20by%20auditors2.pdf (para. 2.4 page 10)

[66] Financial Reporting Council Audit Inspection Unit 2009/10 Annual Report, 21 July 2010.

ability to learn and develop skills beyond audit and accounting is more attractive to recruits.

d) Secondment opportunities to work in specialist areas, such as valuation and business recovery services, provide auditors with new skills and they return to audit better equipped to challenge management and to apply the level of professional judgement necessary in today's complex financial reporting environment.

e) Profitable, growing multi-disciplinary firms are less dependent on the fees from any one individual audit client. As a result they are better able to deal in an objective and unbiased way with potential conflict with management over issues that arise in the course of the audit.

f) The co-location of other professional services with a regulated audit business ensures that the culture of objectivity and professionalism pervades all of the firm's activities.

The relationship between sound corporate governance and the external audit function

33. The key organs of corporate governance are the board of directors and the audit committee which set the tone for the organisation as a whole. As such, their relationship with the external audit function is important to ensure public confidence in UK companies. Internal audit is intentionally an internal function of a company which is established to respond to the needs of management.

34. Audit committees have a vital role to play in promoting sound corporate governance and in challenging management. There is already provision for dialogue between the audit committee and the external auditor but we recognise that external investors would welcome greater insight into the nature of that dialogue. Audit committee reports to investors currently focus primarily on procedural issues but they could be expanded to address the significant issues raised by the auditor in their report to the audit committee. This could embrace the significant risks of material miss-statement in the financial statements, alternative accounting treatments and the principal matters of judgement discussed with the audit committee and would provide stakeholders with greater insight into the external audit function and the way in which the audit committee is discharging its role

24 September 2010

Sir Michael Snyder, Professional and Business Services Group

This paper is submitted on behalf of the Chairman of the Professional & Business Services Group, Sir Michael Snyder, and gives an overview of issues and topics discussed within the Group meetings. The P&BSG was recently established to advise Government on the policy framework to promote the competitiveness of the UK professional and business services sectors. The P&BSG will be providing consolidated advice to Ministers later in the year but we consider that one of the topics under discussion, namely the limitation of professional firms' (not only auditors') liability to parties with whom they contract, and to third parties, is

germane to your Lordships' consideration of market concentration in the audit market. Ministers thought we should therefore offer a contribution to your own enquiry.

Our principal submission to the Committee is that, so long as auditors are not able to limit the liabilities we mention, then the capacity for the market to admit competitors outside the Big Four will be restricted. In our view, a new statutory form of limitation, based on fairness and balance to all stakeholders, on the one hand, and the promotion of competition as a legitimate and proper deployment of public policy, on the other hand, is necessary and urgent.

We preface our remarks by also noting that a number of papers are in preparation in relation to a number of questions raised, in particular:

- the role of auditors looking forward, and whether they have any case to answer so far as the causes of the financial crisis of 2008 are concerned;
- conflicts of interest between the services auditors provide and those other services their firms supply to audit clients; and
- corporate governance.

The brevity of our answers to these issues reflects the above and the Committee will wish to consider these forthcoming reports in the context of its own enquiry

To conclude these initial observations, we confirm we would be happy to present further evidence, either oral or written, at your discretion.

Our answers to the Questions are as follows:-

Q1 Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete? In addressing this question, it is perhaps worthwhile recalling that the present dominance by four firms has only come about in little more than the past 20 years and the largest single change was perhaps brought about by the demise of Arthur Andersen, one of the biggest firms, at the turn of the century.
We consider that the growth in concentration, brought about by business rationalisation, had two main causes:

- globalisation of business required audit firms to expand in order to meet the needs of trans-national clients;
- the statutory regulation of audit, which began with the introduction of the Companies Act 1989, and obliged Recognised Professional Bodies (essentially, the Institutes of Chartered Accountants, and the Association of Chartered Certified Accountants) to license audit firms. The licensing process was itself determined by firms' ability to satisfy 'fitness and properness' criteria. In the course of the next two decades, the regulatory framework for auditors became more sophisticated and exacting (arguably more so for auditors than any other profession: case-by-case examination of auditors' conduct and competence is likely unique to their profession). That process caused the numbers of firms entitled to be licensed for the conduct of audit to contract substantially, as systemic weaknesses were identified and audit became the province of specialist practitioners. The advent of the Financial Reporting Council and its operating arms, the Professional Oversight Board, the Auditing Practices Board, and the Audit Inspection Unit, brought the rationalisation phase to a virtual end, introduced a competence-measurement one, and has formed a platform for a third phase, the audit competition phase. There is a co-efficient of audit firm-size and capability to service larger audited entities but the overall standard of audit is very high and the next tier of firms have invested heavily in the international associations to which they belong. The growing

systemic capability, both in UK and international terms, may allow firms which do not currently participate in the larger end of the audit market to participate, should a real opportunity present for them to penetrate that end of the market.

We should add that, having played its part in contributing to overall audit quality, the regulatory framework now needs to focus on where the systemic risk to the economy is greatest and be commensurately tempered where possible to ensure that audit firms do not face disproportionate regulatory burdens or costs. This is particularly so in respect of firms servicing the SME community, including companies listed on the AIM and Plus markets. The Audit Inspection Unit is also seeking to extend the boundaries of restrictions on professional firms beyond that set by the Auditing Practices Board, making it even more difficult for smaller firms to carry out listed company audits That seems to us unnecessary and contrary to the Better Regulation Principles.

There are a number of ways that one might assist the audit market-penetration process but in our submission, limitation of liability is a key barrier to the entry of smaller audit firms to the larger end of the audit market and should be addressed without delay, although it is not the only factor. We expand on this thought below (see our answer to Q11).

Q2 Does a lack of competition mean clients are charged excessive fees? We should begin by reiterating that the audit market as a whole is not subject to a lack of competition.. There is no empirical evidence to suggest fees charged to clients are excessive,although, inevitably fee payers do from time to time believe that such charges are too high.

Q3 Does a narrow field of competition affect objectivity of advice provided? The Ethical Standards for Auditors (promulgated by the Professional Oversight Board) and the Codes of Conduct (promulgated by the audit licensing bodies) are an essential part of the regulatory framework for the profession. Firms are measured by the bodies granting their audit-licences and by the Audit Inspection Unit against compliance with the Standards and Codes. The tried and tested 'threats and safeguards' approach taken by regulators provides a robust template for ethical behaviour and underscoring auditor integrity.

Q4 Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere? The relationship between auditors and those who have the stewardship function in audited entities is a complex one but all auditors have certain characteristics not necessarily shared by company directors: professional training and qualifications, and membership of a professional body. The emphasis of auditors' training is independence and objectivity, and being able to show independence *in fact*, and there is considerable academic evidence to support the contention that the content and exacting nature of auditors' training, including the compulsory examination of candidates' awareness of, and ability to apply, the Standards and Codes in practical auditing situations, together with membership of a professional body, provide a reliable guarantee of professional behaviour. As noted above, the ethical framework already in place is both robust and effective.

Q5 What is the role of auditors and should it be changed? In response to this question we would note that there is substantial current work already underway (sponsored by the Financial Reporting Council and the Financial Services Authority) to which the Committee ought in our view to have regard. Audit firms will undoubtedly also wish to express their own views.

Q6 Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor? We have not responded specifically to this question and the Committee may wish to consider reports already in preparation.

Q7 What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks? A question asked in quite similar terms already by the Treasury Select Committee of the House of Commons, there is no evidence to suggest auditor-failure in the run-up to the crisis. We again commend the Committee to have regard to the other work going on in these respects.

Q8 How much information should bank auditors share with the supervisory authorities and vice versa? It may well be that the extent of 'regulatory disclosure' (both from auditors to bank regulators and flowing the other way) will change in the future, a process informed by the current work of the Financial Reporting Council and/or the Financial Services Authority.

Q9 If need be, how could incentives to provide objective and, in some cases, unwelcome advice to clients be strengthened? It is a misunderstanding of professional conduct to suggest that it is possible to 'incentivise' auditors to give objective or unwelcome advice: their training and experience sensitise them *against* providing partial or biased advice. Indeed, auditors are already bound by professional standards that preclude the provision of anything *except* objective advice; that is incentive enough.

Q10 Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated? Conflicts of Interest, as we pointed out above, are addressed in the context of the Ethical Standards for Auditors. Our principal observation, though, is that in the vast majority of cases, the service to the client is improved, not compromised, by auditors' ability to provide NAS. All companies like the facility of a suite of advice alongside the satisfaction of their Companies Act obligations. Government will be in the best position to judge, from the conclusions of its enquiry into the banking crisis, whether there is any impairment of objectivity brought about by dual-provision but we do not believe there has been. Indeed, the latest consultation paper emanating from the Auditing Practices Board on the provision by auditors of Non-Audit Services appears pre-disposed to the conclusion that dual-provision is fundamentally good for business and controlled adequately by the 'threats and safeguards' approach; the responses to the previous consultation on NAS indicated that the market is comfortable with the status quo.

Q11 Should more competition be introduced into auditing? If so, how? Though audit firms may have specific suggestions for encouraging competition, one major factor which acts as a barrier to entry for smaller firms entering the large audit market is limitation of auditors' liabilities. Other factors, for example, are reputation al risk, scale, and previous experience.

We have been asked by BIS to develop a model of proportional liability for all of the professions. Limitation of liability would remove the discouragement they presently experience, lest the level of a claim for damages against them should exceed their assets and the professional indemnity insurance cover they hold. Indeed, firms are very unlikely to be able to find the levels of PII cover they would need to discharge a claim of sufficient size: PI insurers simply do not provide adequate levels of insurance, a difficulty that has been addressed in another Commonwealth jurisdiction, Australia. Australian professional standards legislation allows professional bodies to register with a government oversight body on behalf of their practitioners a scheme which provides all the protections for consumers

and other stakeholders (concerning training, education, codes of conduct, and monitoring) which would be easily replicable in the UK. Successful registration means that the professional firms can elect from a number of means of providing proportional liability.

In response to the BIS request, and as one possible method of addressing this issue, we are developing advice on how the Australian model might be introduced in the UK. In the meantime, we would advise the Committee that the audit profession and indeed the other liberal professions could better compete and grow at home and abroad if a workable form of liability-limitation was in place. The European Commission has already concluded that, "in order to ensure a sustainable international audit market, more players are needed to meet the demand by international companies", and has encouraged Member States to give effect to meaningfully functioning means of limiting auditors' liabilities. The opportunity to fulfil both UK and European public policy objectives presents now, in our opinion.

Q12 Should the role of internal auditors be enhanced and how should they interact with external auditors? The role of the internal auditor is essentially different from the external function: it has a different focus and different reporting lines. The size and speed of financial transactions differs enormously between sectors and the internal audit function of a firm needs to be commensurate with that firm's exposure to risk in relation to those transactions. External auditors can and should advise firms of the adequacy of their internal audit processes, eg to protect the shareholders from fraud, but it is important for objectivity and audit independence that dealings between the two are at arm's length.

Q13 Should the role of audit committees be enhanced? Our view is that the current consultation on the provision by auditors' firms of Non-Audit Services will result in an increased role for the audit committee in approving non-audit services supplied by the auditor, in order to increase perceived transparency and to make it clear to other stakeholders that the entity, as well as the auditor, has considered any perceived or potential problems arising from dual-provision. The Financial Reporting Council has already proposed revisions to its guidance for audit committees and we are not aware that further change is necessary.

Q14 Is the auditing profession well placed to promote improvement in corporate governance? The auditing profession can certainly assist in promoting good corporate governance by, for instance, advising clients on the extent to which their corporate governance does or does not comply with the Combined Code, and sharing examples of best practice. The profession can, and does, assist by providing feedback on proposed new corporate governance requirements when they are still at a draft stage.

24 September 2010

Memorandum by Mr Graham Roberts

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1 Introduction

1.1 I am writing in a personal capacity. I am the Finance Director of The British Land Company PLC, a FTSE100 company. I am also a non-executive director and Chairman of the Audit Committee of Balfour Beatty plc, a global infrastructure business with a turnover

exceeding £10billion and operating with 50,000 employees in 100 countries.

1.2 The first 20 years of my career were spent in the auditing profession of which 12 years as an audit partner, initially at Binder Hamlyn and subsequently Arthur Andersen.

1.3 I have therefore seen many sides of the audit debate and its practical application. I also worked at the most senior level at the last audit practice to compete for global clients with what is now called the big 4 but was originally the big 8.

2 Competition. Auditors are an important part of the regulatory framework. I do not however believe competition makes for better regulation or better auditing.

2.1 It is not the number of firms engaged that matters to audit quality but the number and quality of committed auditors employed and the support framework around them.

2.3 When competition in auditing was introduced in the 80s, the response from Boards and auditors was enthusiastic but destructive to the reputation of financial reporting in the UK at that time. The regulatory regime did not cope nor did checks and balances within the firms and their clients. There were lots of causes but failure to counter the negative effects of increased competition was at the heart of it.

3 **Quality.** The regulatory response to the 80s/early 90s debacle in particular the establishment of the FRC and related bodies and the development of audit committees has created a virtuous circle of open communication and checks and balances.

3.1 As a result there have been precious few ‘audit failures’ since the mid 90s in the UK compared to other countries. None have had systemic consequences (but see banks below.) I think the overwhelming evidence is that financial reporting has been improving at a time when the number of firms has been reducing.

3.2 The increased presence and quality of audit committees improved the reliability with which the auditor’s views are heard and discussed in the right way in the boardroom.

3.3 Also audit firms became bigger and this was important because businesses going global were increasing in size and complexity. The perception of financial independence is essential and if the clients get larger so must the firms. This for me was an important driver for the merger in 1994 of my then firm with Arthur Andersen.

3.4 Any regulatory proposal arising from the Select Committee’s review should in my view ensure that the firms can at all times demonstrate financial independence.

4 Professional scepticism. Whilst not all auditors will be perfect all the time, I believe the firms’ cultures have moved dramatically over 20 years to be the best available framework for nurturing and exploiting the talent we have in this field. We also remain spoilt in this country in finding that audit firms have been able to position themselves to source better quality enquiring minds direct from university than other regimes where the profession is less well established or regarded, including the US.

5 Today’s Boardroom challenge. The boardroom challenge, I believe, is to improve the non-financial aspects of corporate reporting and ensure in the process that boards and

investors understand the risk tolerance and risk management of businesses.

5.1 Not that business should stop taking risks – that remains essential to create wealth.

5.2 The boardroom scandals in the UK of the last 15 years have not been around financial misreporting but were more to do with the failure to assess and adequately communicate business models and risk. The massive increase in disclosure obligations over this time horizon has also added to the problem of seeing the wood from the trees: an issue for preparers as well as readers of Company Reports and Accounts.

5.3 Markets can work for the good to act as a check on excessive risk taking and weak business models but both need to be visible to the market. Transparency in this area is the next Holy Grail but it is not an easy challenge. The hardest part, I think, is articulating risks that are not the day to day risks companies manage but the remoter risks which are accepted, as they are deemed remote and are uninsurable, but if they happen can be very damaging, if not fatal.

5.4 Boards probably spent more time and money assessing and protecting themselves from the notorious year 2000 IT risk than any other remote likelihood, high impact risk. That seemed to many an unnecessary expense, viewed with hindsight, but I know of no company with IT dependency that gambled and did no preparation.

5.5 Had Northern Rock articulated internally and externally the risk of wholesale funding dependency would that have driven a discussion at board level and with the regulator about a plan B? The risk of deep sea oil and gas drilling seems clear to me and should have logically led to a dialogue between BP and its peers with the US government on catastrophe risk management drilling off the US coastline well before this incident. I wonder if that happened?

6 Relevance to auditors. I think we have made great strides in achieving reliable financial reporting in the UK. The next step has to be improving how well business communicates on non-financial matters, specifically risk management and business models. It needs to do so in a way which is better than the boilerplate disclosures seen in US style reporting and be accessible to investors and commentators. It will not be easy, particularly with the most complex groups.

6.1 I think in the future that Boards and Audit Committees may well want more external independent evaluation of how they articulate their risk and reward strategies and profile and that audit firms may well need to recruit new skills to fully contribute by questioning the quality of disclosure rather than merely confirming management has evidence to support what they are saying. Today auditing remains a financially orientated process but should, in my view, evolve to a broader business reporting process to support boards in improving governance and transparency.

6.2 The sting in the tail of this proposal is that the investment needed to evolve in this direction can probably only be made by global giants. Access to capital is an issue as well as intergenerational profit sharing at the firms, ie investing for the future poses serious challenges to the firms' demography and reward structures.

6.3 I believe the debate about increasing competition is the wrong discussion. Changing the mix of skills to support boards in their wider reporting responsibilities is a more valuable

goal. I understand the FRC are looking into the role of auditors in non-financial reporting. I think the role of auditing should be resolved first before any conclusions are reached on auditor market concentration risk.

7 The banks. The most extreme corporate scandal and the most challenging for outside observers to grasp is the banking crisis. The scale and complexity of our banks clearly posed difficulties for their Boards and Audit Committees in understanding fully the risk profile of their businesses. This appears to have been the same for their auditors and regulators.

7.1 I was impressed by the clear articulation in the Treasury paper issued in July 2010 on the 'regulatory underlap' between HM Treasury, the FSA and the Bank of England, which was the source of the systemic weakness in the banking regulatory model. I think a similar description would be fitting for the micro-regulatory environment specifically the interaction between auditor, Audit Committee and FSA on individual banks supervision.

7.2 I was involved in bank auditing in the early 90s under the previous regime when banking supervision was done by the Bank of England and found the bi-lateral and tri-lateral meetings very effective in ensuring the auditor's scope of additional work for regulatory purposes covered the areas the regulator should be aware of. I understand this effective method of communication fell into disuse under the FSA.

7.3 Without good dialogue between regulator, bank and auditor it is hard to see how auditors or regulators can do their jobs effectively. The biggest risk that does not seem to have been articulated was the business model weakness around the potential loss of wholesale funding.

7.4 Yet the consequence on asset values of such extreme liquidity loss is severe. Add to that the excessive leverage of certain structured products which amplify losses to catastrophic proportions in a liquidity crunch scenario. The weaknesses of mark to market accounting did not help either, nor did the widespread failure to understand the difference between accounting for losses on an incurred basis rather than an expected basis.

7.5 Looking at the complexities of all these interlinked issues, there is a question in my mind about what reporting lines best suit bank auditing compared to other businesses that are less financially geared and so less susceptible to sudden failure through loss of creditor or depositor confidence. For example, uncertainties surrounding going concern spelt out in an auditor's report on a bank can rapidly become an unfortunate certainty. That is not necessarily in the public, depositors' or the investors' interests. The risk that caused the uncertainty needs instead to be communicated swiftly and dealt with well before any annual report is signed off and through a 3 way dialogue between auditor, board and regulator. Ensuring such communication works effectively is essential.

8 A repeat of Andersen? On a pragmatic basis I cannot see on a global basis how the regulatory mistakes that created 4 from 6 can be unwound, without risk to audit quality. I think instead the answer lies in a version of the 'living wills' approach to banks and not in seeking the riskier rapid expansion of the smaller firms. This would of course require global coordination amongst regulators.

September 2010

Memorandum by Royal Dutch Shell plc

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

Economies of scale were clearly a factor in the consolidation of the auditing industry. Increasing globalisation in recent years has given further impetus to this process as multi-national companies have sought the geographical presence and breadth and depth of technical expertise which can only be provided by truly global auditing firms.

It is difficult to see how the gap between the Big Four and the next tier of audit firms may be bridged. The level of investment required to offer a consistent high quality global service is more important than economies of scale in determining success as a global service provider. Significant costs would be incurred - for example in establishing the necessary structure and expertise and in meeting additional regulatory requirements.

2. Does a lack of competition mean clients are charged excessive fees?

The existing structure of the market does not necessarily mean that audit fees are excessive. They are subject to the same commercial negotiations between client and service provider as any other contractual arrangement. However, it is possible that if there were more firms with international reach and expertise, the increased competition would affect overall fee levels in the long run.

3. Does a narrow field of competition affect objectivity of advice provided?
4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

Auditors give an opinion rather than advice. Because of the need to maintain their professional integrity and meet oversight requirements, we do not believe that limited narrow field of competition should result in any compromise in the quality of service or objectivity of that opinion.

5. What is the role of auditors and should it be changed?

The auditors' role should continue to focus on providing an opinion on the financial statements and other matters as set out in the Companies Act 2006 (and, for Shell as a Foreign Private Issuer in the USA, an opinion with regard to internal control over financial reporting pursuant to the Sarbanes-Oxley Act). At present we see obvious benefit to our shareholders and other stakeholders of widening this role.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?
7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?
8. How much information should bank auditors share with the supervisory authorities and vice versa?

Not forming part of this sector we are not in a position to comment on the role of auditors in the financial services sector.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

We believe that auditors already have the necessary incentives (and powers as captured in relevant codes and regulations) to remain objective in their dealings with clients.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

To avoid any potential risk of a perceived conflict of interest in forming an appropriate audit opinion, requirements are necessary to restrict auditors taking on consultancy work for their clients (we have mechanisms in place to monitor any incidental non audit services).

Certain work may not technically be labelled as "audit" (such as interim reviews) but is complementary to the audit itself. These costs should be disclosed but under certain circumstances use of our auditors provides efficiency benefits and would not comprise their independence.

11. Should more competition be introduced into auditing? If so, how?

Please refer to our responses to Questions 1 and 2 above. As regards the practicalities ,we do not see that there could be a market-based solution in the foreseeable future, and believe that any more invasive interventions such as forced de-mergers or explicit restrictions on firms to either audit or consultancy work would need careful consideration to ensure the interests of clients are not adversely affected.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

We do not believe any further regulation is needed with regard to internal audit. The role and the scope of activities of the internal auditors differ from those of the external auditors. However, it is important that there is interaction, particularly in the areas of risk and internal control. This promotes improved insights for both parties and, with appropriate co-ordination and testing, external auditors should be able to, in part, place reliance on the work of internal auditors thereby driving efficiencies in the process.

13. Should the role of audit committees be enhanced?

Whilst any guidance should be reviewed from time to time, we believe that the role and responsibilities of the audit committee as set out in the FRC's Corporate Governance Code (June 2010) and its Guidance on Audit Committees (October 2008, subject to consideration of any amendments resulting from the current consultation process) are appropriate and comprehensive.

14. Is the auditing profession well placed to promote improvement in corporate governance?

We would expect that the auditing profession, along with other stakeholders, is well placed to continue to contribute to future consultations to ensure that best practice in corporate governance is maintained.

21 September 2010

Memorandum by The Lord Smith of Kelvin

I am writing in a personal capacity with views which may help the committee's consideration.

By way of background, I am Chairman of two FTSE 100 companies, served on the FSA and the FRC and chaired the FRC committee which produced the Smith Report on Guidance to Audit Committees. I am a past president of the Institute of Chartered Accountants of Scotland and spent a lifetime in venture capital and fund management.

Dealing with your questions:

1. Why did auditing become so concentrated on four global firms?

Businesses in all sectors of advanced economies have tended to merge to deal with international markets. Smaller businesses serve local needs. Auditors to the larger global companies are therefore themselves global so that they can provide global coverage, global standards and the level of technical service and training not available in small accountancy firms. Thousands of private companies in the UK use hundreds of local accounting firms who can provide the local service they require.

A look at the FTSE 100 shows that the vast majority of turnover, profits and assets come from outside the UK. This applies as much to oil, engineering and mining companies as to pharmaceutical, technology and financial services companies. These large complex and global businesses need large, technically advanced, global auditors. Even retailers in the FTSE 100, by their nature providing local services, are very large complex businesses.

2. Does a lack of competition mean clients are charged excessive fees?

No, I do not believe auditors charge excessive fees. Indeed, there is a danger that if they do not at least cover their costs, the quality of the audit could be compromised. Non executive members of the audit committee who ultimately decide on auditor appointment and remuneration will see regularly the level of fees in different companies. I do not think that excessive fees are an issue here.

3 & 4. Does a narrow field of competition affect objectivity of advice provided or does it make it easier to provide unwelcome advice?

No, objectivity is not improved by more competition or by lower fees. Objectivity is about strength of character and ethical behaviour.

5. What is the role of Auditors and should it be changed?

These duties are set out clearly in the Companies Act 2006 and in many publications by the Institutes of Accountants.

You will be aware of the May 2009 Treasury Select Committee on the Banking Crisis which was concerned that the audit process may result in "tunnel vision".

Auditors are not paid to run the companies they audit; indeed, they can really only audit the process of risk assessment in a business. There are risks in any business. It is the duty of the board to assess those risks and decide what level of risk is worth taking and what mitigation is available if things start to go wrong. This could be a decision to move manufacturing, say, to the Far East with its attendant risks or to decide not to move manufacturing overseas with its attendant risks, to sell a business or buy a business. Risk can be, among other things, regulatory, financial, reputational, risk associated with the ability to recruit, train and retain staff, develop new products and enter new markets. All companies I have been involved with have a risk map/risk register but the most difficult thing is not to assess likelihood and impact but to think of new or undiscovered risks that could damage the company (Donald Rumsfeld's unknown unknowns).

External auditors cannot easily contribute to this process but they can ensure that a good process is in place. Risk is fundamentally a matter for the whole board, not a risk committee, although detailed work could be done in committee.

However, a lot of audit work is around accounting standards and ensuring compliance with financial reporting standards. In my young days, as an apprentice chartered accountant, the overriding maxim was not whether accounts were exactly accurate but whether the results were true and fair and ones on which reliance could be placed by those investing in, trading with or working for an entity. Perhaps the accuracy, compliance with standards, detail, length and complexity of sets of accounts make the reading of them and therefore reliance on them somewhat difficult. I suspect even professional, sophisticated investors have difficulty judging the health or future prospects of a company from its published accounts. Another major tenet I remember from those earlier simpler days was the Principle of Conservatism, sometimes referred to as "profit smoothing". I was interested to see suggestions by very senior regulators recently that big banks should put aside profits and build up reserves in good times (presumably instead of increasing bonuses and dividends) and use those reserves and reduce capital in difficult times – a somewhat Biblical response that recalls those earlier days.

I do think that auditors should report on "going concern" but not as a boiler plate statement, more of a commentary on any concerns they have or indeed reassurance they can give to users of accounts. I can tell you that auditors do challenge what is said in the Chairman's and CEO's statements as well as in the body of the accounts. It might help if they were obliged to say something on this area in their report.

6&7 Were auditors sufficiently sceptical when auditing banks and what could they have done to mitigate the crisis?

I am not close enough to these events to comment on whether greater scepticism would have helped. I am certain lack of competition was not a contributory factor.

In my maiden speech in the House I spoke about complex products in banking and a lack of understanding of risks being undertaken. However, governments in several countries were encouraging wider home ownership, house buyers wanted 120% mortgages with low interest rates and deferred repayments, bankers made money repackaging loans and "spreading the risk", regulatory authorities were well aware, or should have been, of the build up of assets in our banks and of their reliance on wholesale deposits/loans from other big banks and investors were overwhelmingly supportive of the growth of the banks and their acquisitions and rights issues. Quite what an auditor, given the duties detailed in the Companies Act, could have contributed against this background is unclear. If an auditor had suggested that at some point in the future big banks would not lend to other big banks at any price I am not sure what a board could, or would, have done about that. To eliminate reliance on wholesale deposits and announce that they were in future going to depend on retail deposits would mean a total collapse in share price as the banks reduced in size. Government would have deplored the withdrawal of funding to SMEs and home owners, investors would have been appalled, rating agencies aghast, employees fearful of job cuts and boards would have been obliged to resign.

Because banks could not value the huge sub prime assets because there was no "market price" liquidity disappeared. Even if the banks had had twice the capital that would not have saved them. Only Governments at that stage could supply the necessary liquidity.

8. How much information should bank auditors share with supervisory authorities?

Bank authorities need to know everything and bank auditors should share with them as much as they are legally allowed to do. I do not know what rules of confidentiality govern supervisory authorities but it would seem surprising to me that if an authority had information that would affect an auditors assurance of a company's report and accounts that that information would be withheld leading to misleading information in the marketplace.

9. How could incentives to provide objective advice be strengthened?

Auditors do give unwelcome advice; a lot of discussion goes on between auditors and audit committees and management. No incentive produces objectivity. This is a behavioural and ethical issue.

10. Do conflicts of interest arrive between audit and consultancy roles?

Conflicts can arise, that is why in the Smith Report we insisted on a policy on non audit fees with limits to be set. Sometimes an auditor can be used for advice, on say tax, but auditors should not be doing work which they subsequently have to audit. The audit committee is the watchdog and has to report to shareholders. This works well.

11. Should more competition be introduced in to auditing?

Some medium sized firms are more content to do consulting work (eg due diligence, advisory) rather than staff up to do a large company audit which is not that remunerative. I do not think more competition is needed.

12. Should the role of internal auditors be enhanced?

Absolutely, internal audit is vital. Internal auditors probe deeply in to an organisation and can detect changes in behaviour. A book on recent corporate failures by Professor Stewart Hamilton demonstrates that the seeds of failure lie in behaviour e.g. dominant CEOs, greed, hubris, desire for power, poor strategic decisions and over-expansion. Internal auditors are best placed to detect these behavioural changes which can lead to serious problems. Internal audit needs to have a high status in companies and as with external audit direct access to the audit committee. External audit already place considerable reliance on the work of internal audit.

13. Should the role of audit committees be enhanced?

I believe the framework is there. The audit committee can exercise a powerful role in all companies at present. They need to use internal audit well. They can oversee risk committee procedures but risk, as I mention above, is the responsibility of the full board.

14. Is the auditing profession well placed to promote improvement in corporate governance?

Yes, absolutely.

21 September 2010

Memorandum by the UK Shareholders' Association Ltd

INTRODUCTION

About the UK Shareholders Association Ltd (UKSA)

1. UKSA is the leading independent organisation which represents the interests of private shareholders in the United Kingdom. We campaign to protect the rights of shareholders in public companies, and to promote improved standards of corporate governance. Our educational activities, regular regional meetings, company "analyst" meetings and the resources of our web site, help to inform the public on investment management. UKSA is a "not for profit" organisation which is financed by its individual members.

2. In accordance with the terms of the Companies Act, 2006, auditors report to the members (shareholders) but in practice they deal entirely with the directors without even an opportunity for the members to question them at the AGM. We believe that this is a significant factor in weakening the accountability of auditors, and the companies they audit, to the owners of those companies. This concern has been reinforced by the recent banking problems none of which appear to have been anticipated by auditors.

AUDITORS: MARKET CONCENTRATION AND THEIR ROLE

Effect of and reasons for market concentration

3. There appear to be conflicting factors at work here. The very limited number of firms

involved in the audits of large listed companies ought to make those firms more confident in challenging their clients. However, the evidence does not support this as is shown by the recent FRC review of 2010 audits which criticises several firms for not showing, and applying, greater scepticism.

4. We believe that it is the depth of resources and their geographical breadth that have resulted in the present level of concentration, rather than economies of scale.

Role of Auditors

5. The role of auditors is to ensure that the accounts show a true and fair view. This should not change but should be reinforced and strengthened.

Audit scepticism

6. It appears that auditors were not sufficiently sceptical in recent bank audits. However their position was compromised by certain accounting standards, such as the rules on providing for bad loans. This does not, though, provide sufficient excuse for the failures which occurred in not ensuring that accounts were properly prepared. There is still in UK law the overarching requirement to ensure that a true and fair view is shown. If it is necessary, in order to achieve this, to override the standards, then they should be overridden.

Supervision

7. In UK law the auditors act under contract to the company to act on behalf of the shareholders. We do not believe that this should be changed by making the auditors part of the regulation process. The obligations of regulators differ from those of auditors and should not be confused.

Objective Advice

8. We believe that the introduction of shareholder committees to which the auditor must report could help here. The auditor should have the responsibility to report what he regards as significant discussions with the board and the outcome of those discussions to that committee which acts on behalf of the beneficial owners. The present audit review process conducted by the FRC will help in due course to improve standards.

Conflicts of interest.

9. To the extent that knowledge of the client gives greater efficiency in the provision of non-audit advice, this has value. However it appears that in the majority of cases consultancy advice will be provided by staff other than the audit team who should know the client well. Thus this potential advantage may not be obtained.

10. If this is so the advantage to the consultancy arm of the firm also being the auditor will be mainly the one of having access to the client via the audit principal. This will provide a conflict if the consultant can explicitly, or implicitly, place pressure on the audit process.

11. We would suggest that research should be undertaken to discover whether the boards of companies genuinely believe that having the auditor as adviser gives real commercial benefit. We would distinguish real commercial benefit from the possibility of placing pressure on the audit principal to the apparent advantage of the management.

12. If shareholder committees were introduced it should be one of their responsibilities to decide whether they were agreeable to the company having advice from its auditors.

Competition in the audit market

13. This was reduced by permitting mergers which, with hindsight, perhaps were inappropriate, coupled with the demise of Arthur Andersen. Various steps have been taken to widen the market but with little success. There is pressure from corporate and agency investors to use the big four on the grounds that they will be "safe". Whether this view is justified is questionable. UKSA would support a fresh consideration, perhaps with the FRC, as to the relative "safety" of the big four as against the second tier.

Audit committees

14. These were introduced to enable those board members with particular and relevant skills to seek to improve the quality of the audit process.

15. Two questions arise:

A. Is there a fundamental problem with accounting that it needs these special skills to be comprehensible?

B. Does the use of audit committees reduce the interest and commitment of other board members, consciously or unconsciously, in ensuring that the accounts for which they are all responsible do in fact show a true and fair view?

Corporate governance

16. The job of the auditor is to report on the accounts. It is not the auditor's job to interfere with the way in which the board acts. The auditor should be able to give advice as to good practice in accounting but it is not the auditor's function to influence the way the board conducts itself.

24 September 2010

Memorandum by Z/Yen Group Limited

Background

In response to your email of 28 July requesting that our firm provide evidence, we set out below some information which we hope aids your inquiry. Z/Yen Group Limited (Z/Yen) was founded in 1994 as a commercial think-tank in the City of London to promote societal advance through better finance and technology. Our clients include the majority of global investment banks and many other financial services firms, but also clients in other sectors, such as technology, government organisations and non-governmental organisations. Three accountants were among our founders, two of whom remain as directors of the business today. Our interest in the proper functioning of markets, and our research studies, have led to many of the observations and references below, and our desire to aid your inquiry.

Overall Comment

We would preface our remarks by noting that there are several different audit markets both internationally and in the United Kingdom. A quick categorisation of these markets might be – small and medium-sized enterprise (SME) audits, audits for SME firms listed on exchanges, audits for large firms not listed on exchanges, and audits for large firms listed on exchanges. One can identify other sub-sets of interest, e.g. audits for large firms listed on exchanges with significant international activity or, as is clear from your questions, audits for large financial firms listed on exchanges with significant international activity. The SME audit markets do not exhibit the intense concentration implied in your questions, so our remarks are focused on audits for large firms listed on exchanges and, where appropriate, some comments on the sub-set of audits for large financial firms listed on exchanges.

We would summarise our remarks below as:

♦ the audit market for large firms listed on exchanges is overly concentrated on four firms, and this concentration seems to coincide with lower competition and lack of diversity in approach;

♦ lower competition appears to have resulted in higher prices and poorer service over time and low, if any, productivity improvements;

♦ lack of diversity appears to have resulted in little innovation and, in the case of large financial services clients, increased herd behaviour;

♦ given that auditors have, over time, acquired a preferential economic role (i.e. their use is mandatory for large companies) that allow them to extract economic rents it is right to consider how to ensure a vibrant, competitive market, albeit perhaps less vibrant or competitive than other sectors – as well as what social benefit is given in exchange for a preferential role;

♦ structural changes seeking to increase competition and transparency in the audit market are desirable. Elements of such changes we would consider might include:

➢ enforcing competition policy clearly, which in other markets might lead to capping the market share of the largest firms, or breaking them up, or requiring compulsory audit retendering;

➢ making it easier to take legal action against audit firms for poor opinions;

➢ treating auditing standards under the same regime as ISO standards, i.e. open processes, a single accreditation body (auditor of the auditors) backing certification (company audits) within a competitive market;

♦ structural changes seeking to increase competition and transparency in the audit market we would particularly recommend for closer examination include:

➢ providing ways to ascertain the quality of auditors' performances over time, or 'confidence accounting' as we term it;

➢ requiring audit firms to provide an "indemnity" of some form for their opinions.

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

Concentration was clear by the 1980s, as evidenced by the term "Big Eight", followed by "Big Six" in 1989, "Big Five" 1998 and "Big Four" in 2002. We would pick out for comment:

♦ globalisation – though firms in the 1980s were handling large global corporations, typically through joint audit arrangements;

♦ need for a single firm approach - the large firms often cite the need for single firm arrangements rather than joint audit arrangements, and moves towards single firms have progressed, but equally note that Arthur Andersen very rapidly split into national

components when under stress and the structural arrangements of the large practices are inordinately complicated – 'living will' proposals for banks might find analogues in auditing firms;

♦ regulation – a variety of licensing arrangements and barriers to entry restricted new audit firms;

♦ cost – large, single firms are presented as more efficient than smaller firms, despite the lack of evidence of more efficiency (in fact, overall costs have increased, which is attributed to increasing costs of compliance);

♦ quality – that larger firms provide higher quality, though there is no evidence to support or refute this.

Your inquiry will undoubtedly have many submissions on similar points, however we would note that the point on quality is paramount. Without available information on audit quality, the only two differentiators are size of audit firm and cost. In a market where corporate finance directors have to justify moving from one audit firm to another, 'justifiable' reasons to move are limited to size and cost. Recall that any move to a new firm which seems to indicate a dispute with the existing auditor will invite adverse comment – "something must be fishy if they had to move auditors". As the industry has become concentrated, and the cost is published (a competing audit firm need only look for their competitor's price in the published accounts), there is little need to compete on price. This leads to size being the only differentiator. Imagine a FTSE100, let alone FTSE top 10, company announcing it had selected to a new, small audit firm. The FTSE100 finance director would be unable to prove to shareholders any move towards a higher quality firm (there is no objective evidence). The only facts would be that the new audit firm is indubitably smaller, and possibly (if the smaller firm so bid) cheaper.

2. Does a lack of competition mean clients are charged excessive fees?

To form an opinion on "excessive" one needs to examine Big Four audit fees over time, including:

♦ audit costs as a percentage of corporate turnover, profit and assets;

♦ profits per partner and comparative salaries for staff against other professionals;

♦ increases in the rates charged against inflation;

♦ measures of risk, i.e. comparing audit costs against share price volatility, profit volatility, balance sheet volatility and company failure rates;

♦ rates of change in appointments and price movements during those changes;

♦ productivity improvements, if any.

3. Does a narrow field of competition affect objectivity of advice provided?

We agree that this is a possible working hypothesis. A Big Four auditor with a client in a defined client sector (e.g. banking) will have a fairly clear idea of what the other three firms might well do in a particular situation. He or she will know the other firms and their teams well, not least because he or she may well have trained, qualified or worked for the other three, and may well see his or her future career depending on finding employment with one of the other three in the event of employment disruption with his or her existing employer.

Further, the narrow field means that, with the profusion of deals and joint ventures, the Big Four are constantly finding themselves working together on similar deals and, arguably, less able to provide advice that conflicts with another firm's.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

We agree that this is a possible working hypothesis. However, we would point out that there are legitimate disagreements on interpretations of financial reporting and that the implication in the question is "the auditor is always right".

5. What is the role of auditors and should it be changed?

This is an intricate question taking in market structures, law, regulation, and numerous other topics. The role of the auditor is to provide an opinion on whether or not financial statements provide a true and fair view. We would not change this. However, sticking to the brevity you requested, we would point out that auditors provide an opinion without a clear indemnity. This is, in many ways, similar to the position of rating agencies who provide an opinion without indemnity (though their defence is largely based on the premise that their opinion falls under "free speech"). Auditor opinions are subject to more direct contractual relationships, but if auditors provide a poor opinion, the suggested recourse is legal proceedings. Commercial and financial legal proceedings are inefficient and expensive, and frequently result in awards out of proportion (both ways) to the commercial effects of a poor opinion. Further, audit firms are opaque structures with ostensibly little capital, i.e. a lawsuit may be of little commercial use.

We would suggest clear indemnities and indemnity rules (or liability mechanisms), for example:

- providing strong guidelines on the range which constitutes a poor audit opinion, e.g. more than a 15% adjustment in the total balance sheet valuation of the prior year;
- a ratio for the indemnity, e.g. five times the audit fee, or up to 10% of the company's balance sheet;
- providing confidence that such indemnities and liabilities are limited, thus encouraging smaller entrants into the market;
- clear arbitration procedures that avoid, as much as possible, high legal costs.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

The financial crises of 2008 certainly bring audit quality issues to the fore. The audited balance sheet and going concern statements for many major financial firms over this period were clearly wrong. Virtually all of the major financial firms were audited by the Big Four. There was no discernible dissension among the Big Four. It would be easy to claim that more variety would have increased diversity of opinion, but we could not substantiate such a claim. One could equally claim that smaller firms would have been even more eager to agree with clients (though it's difficult to see how a smaller firm could have been more eager than the Big Four were) in order to gain clients.

We would argue that, with few or many firms, forcing firms to provide indemnities is the way to increase their scepticism during a boom. If the indemnities were proportionate to the boom, e.g. rise with the valuation of balance sheets, then auditors would have more reason to be careful when needed.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

Auditors were amongst the thick of the banking crisis, recommending balance sheet arrangements and advanced valuation formulae (see entries for Ernst & Young in Jenner & Block's "Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report"). It may seem controversial, but taking into account question 6 above where audited statements were of limited use, rather than seeking to have auditors "contribute to better supervision of banks", would it not be better to focus on getting them to provide better audits first?

8. How much information should bank auditors share with the supervisory authorities and vice versa?

No opinion, nor thoughts on substantive change.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

Objective and unwelcome advice is hard to give. Incentives fall into two categories, carrots and sticks. We put forward our principal 'stick', clear posting of indemnities, above. In a competitive market, the principal 'carrot' is profit. Firms that provide objective advice should become more profitable over time. This can only be achieved if the marketplace has the information to see the quality of advice over time.

We have suggested a fundamental reform of auditing and accounting that would allow external validation of audit quality. The approach is termed 'confidence accounting', where uncertainties (ranges) are presented to investors and managers, rather than discrete numbers. The balance sheet of Company X is worth £Y, plus or minus £Z, and we are 95% confident that it falls within this range. This would make auditing a 'measurement science', cf. with the way most laboratories report measurements. A single number for accounting terms such as profit or balance sheet value is clear and simple, but wrong. Confidence accounting would be the presentation of audited accounts in a probabilistic manner. If an audit firm's estimates move too far outside the stated confidence ranges, their clients would be able to make their own decisions about audit quality. We would refer you to the following publication for more detail:

Confidence Accounting: Putting Essential Uncertainty Back Into Auditing And Accounting	Michael Mainelli	2009	Journal of Risk Finance, Volume 10, Number 3, Emerald Group Publishing Limited

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

There are anecdotal stories of conflicts of interest of course. Evidence of conflicts of interest are difficult to prove, though we would refer to the following publication where we tried to examine this:

The Auditor's Cross Subsidy	Michael Mainelli, Ian Harris and	2003	Strategic Planning Society E-Newsletter, Article 1 . (Also published as Anti-dumping

(Statistical Modelling Of Audit Prices)	Alan Helmore-Simpson		Measures & Inflation Accounting: Calculating the Non-Audit Subsidy, www.mondaq.com)

In our opinion, audit firms hold a special position in law, therefore they have special obligations. The simplest way to avoid conflicts of interest would be to restrict audit firms to audit only.

11. Should more competition be introduced into auditing? If so, how?

Structural changes should be sought with the objective of encouraging new entrants into large company audits and making it easier for clients to evaluate the quality of audit. By implication, yes, this should result in more competitors and better competition. There are numerous suggestions for more competition, e.g. compulsory audit tendering periods. We would particularly recommend for closer examination:

- providing ways to ascertain the quality of audit, for example providing the 'confidence levels' around their measurements that would permit external assessments of auditors' performances over time, or 'confidence accounting' as we term it.
- requiring audit firms to provide an "indemnity" of some form for their opinions, for example "financial statements insurance" as proposed by Professor Joshua Ronen of New York University. For further information:

Accounting: Progress May Lie In Insurance (Put Your Money Where Your Audit Is: Financial Statements Insurance In The UK?)	Michael Mainelli and Joshua Ronen	2006	Financial World, pages 38-39, Institute of Financial Services and Centre for the Study of Financial Innovation

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

External auditing is a regulatory, legal and commercial arrangement. Internal auditing is an internal function structured differently within different firms. Many firms do not have an internal audit function. Further many common internal audit functions are performed throughout many different control systems with or without internal audit function involvement, e.g. procedural compliance being audited by standards organisations or information technology checking stock locations. Internal audit reports to management against management-set objectives and we see little purpose in bringing internal audit into regulatory structures.

13. Should the role of audit committees be enhanced?

The audit is primarily for shareholders. All directors should be acting in the best interests of shareholders. We see no reason for promoting further separation of the interests of the audit committee directors from other directors.

14. Is the auditing profession well placed to promote improvement in corporate governance?

Again, as in question 7, rather than seeking to have auditors "promote improvement in corporate governance", would it not be better to focus on getting them to provide better audits first?

Conclusion

We would emphasise that the financial crises of 2007 to 2009 require serious investigation of reform, including the role of both the professions and their disciplines:

Just Doing My Job: Intelligence Versus Integrity In Financial Professionals?	Michael Mainelli	2010	Journal of Risk Finance, Volume 11, Number 2, pages 235-237, Emerald Group Publishing

May we thank you for your time and consideration of our thoughts and wish you success in your inquiry.

September 2010