



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

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Dear Julian

**CHOICE IN THE UK AUDIT MARKET: INTERIM REPORT OF THE MARKET PARTICIPANTS GROUP**

The Institute of Chartered Accountants in England & Wales is pleased to respond to your request for comments on the Interim Report of the Market Participants Group on Choice in the UK Audit Market.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

**A M BROMELL**

Head of Accountancy Markets & Ethics  
ICAEW



## ICAEW Representation

ICAEW REP 54/07

### CHOICE IN THE UK AUDIT MARKET: INTERIM REPORT OF THE MARKET PARTICIPANTS GROUP

Memorandum of comment submitted in July 2007 by the Institute of Chartered Accountants in England and Wales, in response to the Financial Reporting Council's consultation paper on the Interim Report of the Market Participants Group on Choice in the UK Audit Market.

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute' or the 'ICAEW') welcomes the opportunity to comment on the Interim Report ('the report') of the Market Participants Group ('MPG'): *Choice in the UK Audit Market*.

## WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

## OVERALL COMMENTS

4. The Institute welcomes the report as a useful, proportionate and measured contribution to the debate in the UK audit market. The FRC and the MPG have clearly thought through a complex set of issues where solutions are not always clear-cut. The key driver in this market must be audit quality and focus has rightly been placed on this.
5. Since initiating this debate in July 2005 with an Audit Quality Forum report<sup>1</sup>, the Institute has advocated that market-based actions will prove to be the most effective means to achieve an impact, given the right information. As such actions tend to involve information dissemination, persuasion and education, they may not have an immediate effect. They do however, tend to be more effective as, once accepted, they work with the market, and avoid the unintended consequences that often follow from regulatory actions.
6. We therefore endorse the general approach taken by the report and the intent behind the recommendations. We are particularly pleased to see a recommendation that regulators should consider whether their rules could have a disproportionately adverse impact on auditor choice compared to the benefits of the regulation: the restrictions imposed by regulation and the costs of regulatory compliance are one of the fundamental barriers to entry.
7. In terms of more proactive regulatory intervention, it follows from our comments above that we believe there would be strong evidence of a need for such action. This would include, among other factors, an assessment that there remained an issue and that the market actions following the issue of the report

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<sup>1</sup> 'Shareholder Involvement – Competition & Choice', Audit Quality Forum, July 2005: [www.icaew.com/auditquality](http://www.icaew.com/auditquality).

had failed to have a sufficient impact. It is not clear to us, however, what timescale is envisaged to make this assessment and who should undertake it.

8. We set out our comments on the individual recommendations below. Overall we are supportive of the proposals. We do draw attention to the need for care in a number of instances where there could be unintended consequences, highlighting the need to ensure that those measures addressing perception issues are prioritised. In addition we note that there are some instances where there will need to be additional or different guidance and would be happy to assist.

## **COMMENTS ON INDIVIDUAL RECOMMENDATIONS**

***Recommendation 1 - The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.***

9. As we noted in our response to the 2006 discussion paper<sup>2</sup>, European Union rules would need to be changed to alter the ownership requirements and any action is therefore unlikely to be possible in the short term, although we note the EU is undertaking a study on ownership rules. Nevertheless, in our view the key issue is control of firms rather than ownership. As we stated in our 2006 response, we believe that, in principle, quality requirements could be applied to firm operations rather than ownership, thus liberalising the provision of capital without compromising audit quality. Note that we state 'rather than ownership' as it would be counterproductive if any change to regulatory requirements to achieve this added to the overall regulatory burden.
10. From a choice perspective the reaction of potential capital providers is unclear. The biggest firms may find it most easy to attract capital because of their higher profile and become even more dominant. Alternatively their higher risk profile may deter providers. It is important to ensure that the proposals elsewhere to address perception issues are carried forward in advance of any action on ownership.

***Recommendation 2 - Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.***

11. We believe transparency in the audit market is a good thing and the recommendation is in line with this. In addition there has been particular support for this from business members. However, we do not believe that questions of profitability are the main issue stopping new entrants to the market and it is unclear to us how this will advance choice. We therefore recommend that careful consideration be given to the costs of compliance compared to the benefits.
12. As regards the detail to be reported there will need to be guidance regarding this as questions will arise on, for example, issues such as what "directly related services" are. In the Institute's response to the Professional Oversight Board Transparency Reporting consultation in October 2006<sup>3</sup> we referred to the need

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<sup>2</sup> Available at <http://www.icaew.com/index.cfm?route=140183>.

<sup>3</sup> Available at <http://www.icaew.com/index.cfm?route=143162>.

for further discussions regarding point 5.13(i) on financial information disclosure in the consultation paper.

***Recommendation 3 - In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.***

13. Agreed. We have been consistently in favour of sensible auditor liability limitation arrangements and endorse the liability limitation provisions in the Companies Act 2006 and the efforts of the EC to encourage audit liability limitation across the European Union.

***Recommendation 4 - Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms.***

14. Agreed. Indeed, regardless of choice considerations, it is important that there is appropriate representation from across the range of stakeholders affected.

***Recommendation 5 - The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency of the capabilities of individual audit firms.***

15. We agree with the underlying aim and the importance of an agreed understanding of what audit quality is. As noted in our September 2006 response to the Audit Inspection Unit ('AIU') consultation paper *Reporting on Audit Quality Monitoring*<sup>4</sup>, we encourage caution in considering changes in reporting on AIU inspections, as this may lead to unintended consequences.

***Recommendation 6 - The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.***

16. We note that the EU Statutory Audit directive requires the outgoing auditor to provide access to 'all relevant information', which should address this recommendation, and we are currently taking action to address that, in consultation with the Department for Business, Enterprise and Regulatory Reform.

***Recommendation 7 - The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.***

17. Audit quality is paramount but we agree that there may be circumstances where such quality would not be harmed by the use of auditors from more than one network. Guidance may be helpful although the issue is already discussed in a number of places and existing guidance should be taken into consideration.

***Recommendation 8 - The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision.***

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<sup>4</sup> Available at <http://www.icaew.com/index.cfm?route=142285>.

18. We agree in principle. Transparency in the process may encourage audit committees to consider a wider selection of auditors for tender. However concern has been expressed to us that this could be counterproductive, with audit committees becoming even more conservative to avoid potential criticism that they are contemplating an auditor which is an 'unknown quantity'. Those amending the guidance may wish to consider whether it would be useful for any disclosure to focus on discussion of the procedure for assessing audit effectiveness. In addition, as with Recommendation 1 it is important to ensure that the proposals elsewhere to address perception issues are carried forward and it will be also be important for the FRC to pay particular attention to feedback from members of audit committees to this proposal.

***Recommendation 9 - When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.***

19. Agreed: transparency in the process may encourage banks or other advisers to reconsider any restrictive requirements in this respect that do not have a sound basis. It is important that this covers contractual *or other* obligations as conditions may exist in substance, without being included in contracts.

***Recommendation 10 - Investor groups, corporate representatives and the FRC should develop good practices for shareholder engagement on auditor appointment and re-appointments and should consider the option of having a shareholder vote on audit committee reports.***

20. Agreed. We believe there are some circumstances where audit committees believe investors have a more restrictive criterion in respect of auditors than is actually the case. Measures to encourage investor reaction to information provided by the audit committee are welcome although we share the concerns in the report that they should not be framed to encourage tenders for box-ticking purposes.

21. As regards having a vote on audit committee reports, we are not at this stage convinced that this will enhance choice in the audit market. If there is to be a vote, it should be on the specific issue of the information referred to in Recommendation 8 rather than on other aspects of the report on the way the audit committee has discharged its responsibilities.

***Recommendation 11 - Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.***

22. Agreed. Auditor independence is an important means to an end of high audit quality but it is not an end in itself. Regulators (nationally and internationally) should, going forward, take into account the consequences for market choice of prescriptive rules on independence, when a more principles-based threats and safeguards approach could ensure independence while preserving flexibility.

23. We note and concur with the comments in the report that a five-year rotation period for the lead audit partner on listed entity audits is stricter than necessary. We highlighted the difficulties created by the existing five-year rule in our

response to the FRC's *Promoting Audit Quality* discussion paper<sup>5</sup>. While the five-year rule originated in the changes introduced by the profession in 2002, we do not now believe this change was merited and the IFAC seven-year requirement would be more appropriate. The full effects are yet to be felt but it is already creating difficulties in ensuring that new engagement partners can be put into position with sufficient knowledge and experience of the client to ensure high audit quality is maintained.

***Recommendation 12 - The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.***

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

***Recommendation 13 - Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.***

25. Regardless of the size of audit firm, we agree that speculation about what a regulatory penalty might be is likely of itself to have far worse consequences than the eventual penalty itself (if there is one). Any reasonable measures to reduce this possibility are welcome.

***Recommendation 14 - Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.***

26. We believe transparency in any market is desirable and would not disagree with the application of an appropriate governance code on a 'comply or explain' basis, if it is seen to enhance choice. However, we do not believe that, should this recommendation be taken forward, the Combined Code on Corporate Governance is necessarily the best code to apply: it was designed for listed entities where the concern is to ensure that the Board, as agent of the shareholders, is governing the entity in their interests. The concern in this context is taken to be that audit firms are governed in such a way as to ensure that audits are performed in the public interest. We therefore believe that a task force should be set up to consider developing a separate code, taking into account the requirement of the revised Statutory Audit Directive to publish transparency reports covering the governance structure and the internal quality control system. We would be pleased to be involved or otherwise advise.

***Recommendation 15 - Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.***

27. Agreed: contingency planning for major risks is good business practice regardless of the potential upsides on audit market disruption. However, this should be as part of the overall risk mitigation planning that should be undertaken

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<sup>5</sup> Available at <http://www.icaew.com/index.cfm?route=148712>.

in compliance with the Turnbull guidance, with the Board concentrating on what it sees as the key risks, rather than any specific requirement.

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