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Dear Sir

Choice in the UK Audit Market – Progress Report and Further Consultation

We welcome the opportunity to comment on the Financial Reporting Council's (FRC) paper 'Choice in the UK Audit Market – Progress Report and Further Consultation'. Our response will concentrate on the sections dealing with possible changes to audit firm ownership rules and draft guidance on the use of firms from more than one network for the statutory audit function.

We do, however, have an observation on the progress report and the indication that the FRC intends to publish, at six monthly intervals, such a progress report. (In fact the FRC CEO announced, in his remarks at the FRC Annual Meeting on 17 July 2008, that the next progress report would be published in October 2008 – a five month period). The FRC paper states '*the MPG published 15 recommendations intended to allow the market to work more efficiently and, in the medium to long term, to have a positive impact on audit choice in the UK.*'

In recognising that the effect from the MPG recommendations might only be seen in the medium term, at a minimum, we are surprised that the FRC intends to continue revisiting this area with such frequency. We believe that the limited resources of the FRC would be better served in letting the MPG recommendations have an effect rather than producing papers that repeat the history of this debate.

Changes to audit firm ownership rules

It is disappointing that the FRC has elected to produce a paper, with an invitation for comments, on a topic on which the European Commission has signalled that it will be consulting very shortly. The effect of this approach is that UK respondents will now need to respond to both the FRC and Commission papers. The FRC was well aware, before the publication of its own discussion paper, of the existence of the Commission paper yet has decided to duplicate the Commission's work in this regard.

The current ownership restrictions, for audit firms, that a majority of the controlling board are ‘qualified persons’ (i.e. statutory auditors)¹ is a requirement under European² and national legislation. Therefore, any relaxation in the ‘majority ownership’ criteria will need to come from Europe before any change could be considered in the UK.

Of course, the effect of the current legislation is that external investment up to 50% is allowed in audit firms - yet this does not currently appear to have been attractive with external investors, with very few exceptions.

In considering whether a relaxation of these provisions would bring any benefits, one first needs to consider the possible costs, for example, the implementation of a new system to ensure the independence of the auditor and audit firm from audit clients where any investor has an interest; potential reductions to high quality audit; and greater market concentration from the attractiveness of short term financial returns.

Whilst, as the FRC document identifies, there are a number of regulatory interventions to ensure that the provision of audit work is independent from the audit entity, it is the management of a firm that sets the ‘tone at the top’ and controls the business on a day to day basis. Should the introduction of external investment result in a change of focus away from the production of high quality audit work to that of significant returns on investment, we consider this would be detrimental to the UK capital markets and contrary to the aims of the FRC.

There would also need to be consideration of whether external investors are likely to invest in any audit firm that is subject to civil claims of such value as to ‘wipe out’ the investment. As the Oxera report, prepared for the European Commission, identifies³ *‘the impact of liability risk on the cost of capital might be significant, and may lead to capital rationing, to the extent that outside capital is unwilling to take on liability risk’*.

Whilst the UK has recently implemented legislation regarding auditor liability limitation, the effect of this is still unproven. The effect of liability claims brought in other parts of the world, including other parts of Europe, against an audit firm which is part of a network, would also need to be considered by an external investor.

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

¹ Paragraph 7, Schedule 10, Companies Act 2006

² Article 3(4) of the European 8th Company Law Directive on the statutory audits of annual and consolidated accounts (2006/43/EC)

³ ‘Ownership rules of audit firms and their consequences for audit market concentration’ page iv

factors, such as firm reputation, personal development and increases in income. An individual would either continue to hold or release any equity they held in an audit firm that no longer employed them as they would any other investment.

In highlighting these issues we are attempting to identify that there will be many difficulties to be resolved before all Member States will consider the removal of the long standing 'majority ownership' criteria. If solutions to those difficulties could be found, however, we would strongly urge that any new requirements did not extend to those audit firms who had maintained a majority of qualified individuals on the controlling board.

Draft guidance on use of firms from more than one network

Whilst we support the production of any guidance that will assist market participants to make informed decisions, it is essential that guidance for audit committees is never prescriptive nor suggest a route that committees should take, with the effect that failure to do so will result in criticism at a later date.

This adopts the UK approach to corporate governance⁴ that *'requires a degree of flexibility in the way companies adopt and adapt governance practices. To be effective good governance needs to be implemented in a way that fits the culture and organisation of the individual company.'*

We are also concerned that the production of this guidance may set an expectation that audit committees will need to document their deliberations, which is both disproportionate to the objective and will potentially increase cost to business.

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

Please do not hesitate in contacting Peter Wyman if you require any further information. We are content for this response to be published.

Yours faithfully

PricewaterhouseCoopers LLP

⁴www.frc.org.uk/documents/pagemanager/frc/FRC%20The%20UK%20Approach%20to%20Corporate%20Governance%20final.pdf