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Dear Mr Gadhia

Audit Market Investigation

KPMG Response to Development of Statutory Financial Audit Working Paper

Thank you for affording us the opportunity to comment on the Competition Commission's (CC's) Development of the Statutory Financial Audit Working Paper (the "WP") published on 10 August 2012. We believe that there are some elements of the WP that lack balance and objectivity and need to be addressed (eg paras 42 and 59) and many others where improvements can be made. Our comments are set out in the Appendix below.

We trust that these comments and observations are useful in informing your consideration of the Working Paper. Do not hesitate to contact me if you have any queries or wish to pursue any of these points further.

Yours sincerely

David L Gardner
Director of Public Policy

Appendix 1

Unless otherwise stated, paragraph references are to paragraphs in the Working Paper

WP paragraph	KPMG comment
1	It would be helpful to explain the relevance of the historical development of audit. We do not consider that the term "financial audit" in this and subsequent paragraphs and in the title is correct. The statutory audit is not a general "financial audit", which might imply a general review of financial health, but an audit of the company's financial statements.
2	We agree that the auditing has developed as a result of developments in company law from the 1840s onwards. However, we do not agree with the - unsubstantiated - statement that there is such a direct link with the establishment and growth of audit firms or of their alleged power. Rather, we would see audit developing in response to the demands of case law, companies' legislation and of companies themselves. Under the earliest general companies' legislation, the auditor was not an audit firm but an individual who was required to be a shareholder of the company. Many accounting firms were set up in the 1840s, but their main concern was not auditing but bankruptcy and insolvency work. They also advised companies as they grew in complexity, for example railway companies, on accounting matters. Further detail is given in various articles and text books (some of which we mention below) dealing with the development of company law and the accounting, reporting and auditing requirements. Therefore we consider it would be better to state that the development of company law led to the development of accounting and reporting requirements for companies and to the development of auditing to assist shareholders in holding directors accountable for their stewardship of the company and its assets.
4	There are a number of additional landmark dates that may be worth including, such as: 1942 - the ICAEW starts to issue non-mandatory guidance in the form of Recommendations on Accounting Principles. 1980 – first UK auditing standards and guidelines issued. It is not correct to state that in 1948 "audit firms were given a monopoly of auditing". As set out in paragraph 30 of the WP, the change brought in by section 161 of the Companies Act 1948, as recommended in the Cohen report, was that auditors had to be professionally qualified (or authorised by the Board of Trade). We suggest the wording against 1948 should be changed to: "auditors required to be professionally qualified or have special experience." As Gower and Davies "Principles of Modern Company Law", eighth edition, by Paul L Davies, 2008, explains in section 21-15, one of the key changes in the Companies Act 1989 was the "interjection of a public element into the standard setting bodies". The Act gave "authority to issue accounting standards which have statutory recognition" to the body or

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	bodies considered appropriate by the Secretary of State – the Accounting Standards Board. We suggest this should be included by expanding the comment on the 1989 Companies Act An important recent development was the 2003 case *Royal Bank of Scotland v Bannerman Johnstone McLay and other*, which opened up the possibility of auditor's liability to third parties and led to the addition of the so-called "Bannerman" paragraph to the auditor's report. We suggest including: 2003 – "Bannerman" case decided (paragraph included in auditor's reports to state that the auditor's responsibilities are to the company and the company's members as a body)
5	This paragraph implies that company registration was seen as a mechanism to address issues of bureaucracy and crown payments. However, as is explained, for example in Palmer's Company Law (2007) section 1.103, entrepreneurs were looking for a mechanism to enable funding to be provided for undertakings needing large amounts of capital through shares that could be transferred, and a means (provided by the Limited Liability Act 1855) of limiting members' liability.
10	There are a number of reasons for the quality of information being uncertain. In particular we would suggest this was because there was no agreement on the general principles of accounting or how specific items should be accounted for in financial statements, and there were very few items that needed to be disclosed. The requirement for the shareholders to appoint one of their number as auditor reflected the view that, to be able, and to have the incentive, to challenge the directors' accounts, the auditor had to have the same interest in the company as the other shareholders. Hence they were required to be independent only to the extent of not being directors or officers of the company. If they needed professional advice, they were able to obtain it from the increasing number of professional accountants with relevant expertise.
13	We do not consider it correct to state that there was a stronger policy of laissez faire in 1856 than in 1844. As various articles, for example Edey and Panitpakdi "British Company Accounting and the Law 1844-1900", in A C Littleton and B S Yamey (Eds) "Studies in the History of Accounting" (1956), referred to in R G Day "UK Accounting Regulation: an Historical Perspective", Bournemouth University School of Finance & Law Working Paper 20 (2000), make clear, *throughout the period* the view was that the law should interfere as little as possible in what were seen as matters to be agreed privately between shareholders and directors.
28	There were a number of recommendations relating to accounting and audit made in the Greene Report that were subsequently picked up in the Companies Act 1929, including: ■ Companies were required to keep proper books of account. ■ Directors were required at least once a year to lay the latest balance sheet and profit and loss account before the company in general meeting. Certain items were prescribed as minimum contents for the balance sheet, including information about any subsidiaries.

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	■ Companies were required to include a copy of their latest balance sheet and the auditor's report thereon with their annual return to the registrar of companies. ■ Auditors could no longer be partners or employees of an officer of the company.
30	A recommendation in the Cohen Report, subsequently enacted in the Companies Act 1948, was that auditors should be allowed to make representations to the company if their appointment was terminated for any reason. This afforded some measure of protection for auditors who disagreed with the directors. The meaning of "true and fair view" is discussed in David Flint "A True and Fair View" ICAS Monograph 1982.
31	The takeover by GEC of AEI was a key step leading up to accounting standards because it revealed the very wide range of permissible accounting treatments in financial statements. As described for example in the R G Day Bournemouth University Working Paper mentioned above, a joint report commissioned by the directors from the auditors of both GEC and AEI explained the difference of £14.5m between AEI's forecast profits for the period after the acquisition and the loss arising under GEC's ownership as made up of £5m being attributable to matters "substantially of fact" and £9.5m being "matters of judgment". It is misleading to imply that AEI's accounts were "wrong" and GEC's were "right". Rather, the lessons were the same as those from the proposed but ultimately abortive takeover of Pergammon Press by Leasco in 1969, that there was an clear need to reduce the range of what were then considered acceptable accounting treatments.
31-32	The paper does not mention the Companies Act 1967 and the Jenkins Report which preceded it. In the light of our comments on paragraph 31 above, it is interesting to note that the Jenkins Committee was presented with many of the accounting issues that were being debated, such as the inclusion of valuations in accounts – the so-called "modified historical cost basis of accounting" – and issues around mergers and acquisitions such as the definition and distributability of pre-acquisition profits. The Act did not attempt to settle these questions, but brought in further disclosure requirements for both balance sheet and profit and loss account items. In effect, it recognised that detailed accounting questions were not for legislation but were best left to accountants and increased transparency in accounting. To allow for the fact that the people in a firm appointed as auditors were subject to change, companies were required to appoint or re-appoint auditors at each annual general meeting.
33	Although the provision requiring the auditor to make a statement of circumstances was introduced by section 16 of the Companies Act 1976, this was a strengthening of the provision in section 160 of the Companies Act 1948 that allowed the auditor to make representations on removal or not being reappointed. Our understanding is that the change was because in most cases auditors had chosen not to avail themselves of the right. There are two relevant aspects of the statement of circumstances; first, s 16 CA 1976 focused the statement on whether there were any circumstances that the auditor considered

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	should be brought to the attention of members and creditors. Previously s 160 CA 1948 gave no guidance as to what the auditor's representations should address, only that it should not be used to "secure needless publicity for defamatory matter". Secondly, under the 1948 Act the statement had only to be circulated to the members of the company. The 1976 Act required the statement to be filed with the registrar of companies – but not "circulated" to creditors - recognising that the concerns of the auditors could be of interest to others. Although this was the first time that the word "creditors" was included in a section dealing with audit, we do not consider that it is correct to characterise that as being a provision expressly directed at the protection of third parties. Rather, the provision merely recognised that the concerns of the auditors could be of interest to others but not in the sense of providing them with any "protection".
36	The significance of the emphasis on the words from Article 2 (5) of the 4th Company Law Directive is not clear.
39	The Companies Act 1989 not only introduced reforms and new structures into accounting (for which see below) but made new provision in respect of audit. It was necessitated by the requirement to incorporate into UK legislation the provisions of the EEC Eighth Company Law Directive on the regulation of auditors. As well as requirements relating to company accounts, it introduced a legislative framework for the qualification and regulation of auditors and provisions governing their training, qualification and conduct. It made provision relating to "professional bodies" – bodies to which auditors are required to belong - and "supervisory bodies" – bodies recognised by the Secretary of State as authorised to oversee the profession. Much of this survives in Part 42 of the Companies Act 2006. We feel that it is important to include reference to these other provisions to make it clear that, particularly recently under the influence of Europe, there has been considerable legislation aimed at ensuring high standards of auditing through increased regulation involving both professional bodies like the accountancy institutes and external bodies like the Financial Reporting Council. The more significant audit firms have since been made subject to independent regulation. In addition to recognising accounting standards, s 19 CA 1989 provided that the independent bodies responsible for issuing accounting standards, the oversight and direction of the issuance of accounting standards, and investigation and enforcement should be subject to recognition by the Secretary of State, who was empowered to make public funding available to support them. This reflected some of the recommendations of the 1988 Dearing Report "The Making of Accounting Standards" which, as the foreword to the Report states, were made to meet demands "urging the need for development of the present arrangements for providing accounting standards." Again, it is important to state this so as to make it clear that accounting standards are subject to extensive regulation whose authority comes ultimately from outside the profession. See also our comments on paragraph 51 below, where we explain that the provision of public funding was not introduced by the Companies Act 2004.

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41	We have been unable to find any reference to auditing firms claiming that partnership structures were too unwieldy. It would be helpful to include evidence for this statement. We would expect the debate also to have been influenced by auditors' concern about their unlimited personal liability.
42	We are surprised by the erroneous statement in this paragraph that the introduction of the Limited Liability Partnership Bill was "controversial" when it had cross-party support from all three main parties in both Houses of Parliament. According to the Hansard record for 23 May 2000 vol 350 cc888-916 the Minister the Rt. Hon. Dr Kim Howells MP stated that *"Limited liability partnerships, or LLPs, were first proposed by the previous Administration, and responses to a consultation on the general principles were clearly in favour of their introduction. The Government agreed that the concept had merit and published a draft Bill in September 1998. That, too, was well received, and consultees provided feedback on the detail of the legislation. I should add that consultees represented a wide range of interests, including accountants, lawyers, actuaries, architects, surveyors, academics, trade associations and those representing the potential clients of an LLP. The measure has wide support across the professional business community."* Although not as entertaining as Austin Mitchell MP's interventions, the record of the debate shows that the Bill had extensive support in both Houses and was generally accepted inside and outside Parliament as being a useful addition to the statute book. It should also be noted that at the time of writing there are over 50,000 registered and active LLPs. There are just over 7,000 audit firms registered with the Recognised Supervisory Bodies (the vast majority of which are LLPs), so over 85% of LLPs are other businesses, including lawyers, surveyors, etc. It therefore cannot be right to state that limited liability partnerships are solely or even mainly for the benefit of auditors. LLPs were always supported by a broad range of professional services and other firms, small and large together with their professional associations and the wider business community.
43	We consider that the term "specialised accounting techniques", though perhaps intended as a euphemism, is misleading. It implies that it is considered acceptable in the accounting profession to promote, or acquiesce, in such matters, which is not true. The accounting was not appropriate to the items to which it was applied and was to enable Enron to report earnings that met market expectations and hence to maintain the Enron share price. The words "inappropriate" and/or "fraudulent" appear more appropriate.
43-44	The purpose of including such a detailed discussion of Enron in this paper is not clear. The report of the US Permanent Subcommittee on Investigations quoted in the WP focuses largely on the board of directors and, with the benefit of hindsight, makes clear the laxity and complacency in the board's and audit committee's oversight of the company. The board's performance in ensuring effective control over the company's executive management is severely criticised, as are their failures not only properly to review the transactions presented to them for approval but also to communicate with, and ensure the

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	independence of, the auditors. Matters raised in relation to the auditors, such as the provision of non-audit services to audit clients and issues from reviewing their own work, have been addressed with other issues in the various codes of ethics for auditor, such as the Code of Ethics for Professional Accountants of the International Ethics Standards Board for Accountants (IESBA) of the International Federation of Accountants (IFAC) and the UK Financial Reporting Council's (FRC's) Ethical Standards for Auditors.
47-49	As well as information about the US Sarbanes-Oxley Act and Public Accounting Oversight Board (PCAOB), it would be helpful to include references to developments outside the UK to make clear that developments in the UK need to be seen in an international context. Similarly, what happens overseas has an impact on developments in the UK. For example, the International Forum of Independent Audit Regulators (IFIAR), set up in September 2006, now has members from over 40 countries. Its aims are: ■ to share knowledge of the audit market environment and practical experience of independent audit regulatory activity; ■ to promote collaboration in regulatory activity; and ■ to provide a focus for contacts with other international organisations which have an interest in audit quality.
50-52	The discussion of the Companies Act 2004 is rather narrow and partial. The DTI's Explanatory Notes on the CA 2004 explain that it "forms part of the Government's strategy to help restore investor confidence in companies and financial markets following major corporate failures" and, with other non-legislative measures, is "designed to strengthen corporate governance and audit practice". In the areas of audit and accounting, it is "intended to strengthen the independence of the system of supervising auditors, the enforcement of accounting and reporting requirements, the rights of auditors to information and the company investigations regime." This makes it clear that, like previous Companies Acts, the 2004 Act continues to move legislation towards greater public involvement in and oversight over all aspects of accounting and audit.
51	This paragraph should be amended to make clear that the 2004 Act only extended the Secretary of State's existing powers in s 256(3) of the Companies Act 1985, inserted by the 1989 Act, to provide public funding to bodies issuing accounting standards, overseeing and directing the issuing of such standards, investigating departures from standards or the accounting requirements of the Act and taking steps to ensure compliance with them. As explained in the Explanatory Notes on the CA 2004, this power had been "used to fund in part the activities of the FRC (Financial Reporting Council) and its two associated Boards, the ASB (Accounting Standards Board) and the FRRP (Financial Reporting Review Panel)". See also our comments on paragraph 39 above.

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52	Rather than mentioning "external quality assurance" briefly in paragraph 54, it should be mentioned here as it was introduced in the UK in the 2004 Act. The independent Audit Inspection Unit (AIU) took over responsibility for monitoring the audits of all listed and other major public interest entities from the monitoring units of the professional accountancy bodies in 2004, with the aim of enhancing independent regulation and oversight. This was the first time in the UK that the inspection of the major accounting firms and the review of some of their more significant audits were put in the hands of an independent body. It issued its first report in respect of its inspections for the year to March 2005. In July 2012 the AIU was re-named the Audit Quality Review Team. "Public oversight over the audit profession" was thus in place in the UK before the Statutory Audit Directive - see the discussion of the AIU in the Professional Oversight Board for Accountancy's 2005 report.
53	Rather than focussing on the EU Statutory Audit Directive (SAD), this paragraph should explain that many of the provisions in the SAD were already required in the UK, because of earlier legislation or by other developments in, for example, the roles and responsibilities of the Financial Reporting Council and its subsidiary bodies and boards and the requirements for auditors set out in paragraph 56. We go into some of these in more detail below.
54-58	The following comments show when and where some of the requirements of the SAD have been included in UK requirements. We have not addressed every matter but suggest it would be helpful to include an explanation in the paper of the relevance of the points.
54	In the UK, the APB's Ethical Standards, first issued in December 2004 (and revised in 2010-2011), deal very largely with independence. The same is true of the IESBA's Code of Ethics for Professional Accountants. These make clear the close connection between ethics and independence.
55	In the UK, paragraphs 22 and 23 of Statement of Auditing Standards 510 "Relationship between principal auditors and other auditors", which was issued in 1995 with effect for audits of financial statements for periods ending on or after 23 December 1995, clarified the responsibility of the group auditor as follows: "When the principal auditors are satisfied that the work of the other auditors is adequate for the purposes of their audit, no reference to the other auditors is made in the principal auditors' report. "The principal auditors have sole responsibility for their audit opinion and a reference to the other auditors in the principal auditors' report may be misunderstood and interpreted as a qualification of their opinion or a division of responsibilities, neither of which is appropriate." The current International Standard on Auditing 600 (UK and Ireland) "Special considerations - audits of group financial statements (including the work of component auditors)", effective for audits of group financial statements for periods ending on or after 15 December 2010, has a corresponding statement in paragraph 11:

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	"The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor's report that is issued is appropriate in the circumstances. As a result, the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference. If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group engagement partner's or the group engagement partner's firm's responsibility for the group audit opinion." The requirement for the audit committees of UK issuers to review the effectiveness of the company's risk management and internal control systems is set out in DTR 7.1."Audit Committees and their functions" of the FSA's Handbook. DTR 7.1.3 states that: "An issuer must ensure that, as a minimum, the relevant body must: (1) …; (2) monitor the effectiveness of the issuer's internal control, internal audit where applicable, and risk management systems;" It is also included in recommendation C.2.1 of the current Corporate Governance Code. However, it has been a recommended in the UK since 2003 when paragraph C.3.2 of the 2003 version of the Combined Code stated that: "The main role and responsibilities of the audit committee should be set out in written terms of reference and should include: ■ …..; ■ to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;" Even these few points make clear that the UK has taken a lead in proposing and introducing developments to enhance the role and independence of financial reporting and audit. Many of the requirements introduced in the various European Union directives were first established as requirements in the UK through Codes or other non-legislative means.
56	These requirements are mainly set out in International Standards on Auditing (UK and Ireland), International Financial Reporting Standards (the replacements for IASs) and the Corporate Governance Code.
57	It would be helpful to explain how the provisions relating to audit fees have been translated into UK requirements.
58	Whilst Sections 534-538 of the Companies Act 2006 for the first time permitted a company, subject to procedures being followed, to enter into a liability limitation agreement with its auditor, this is rarely if ever done. None of our clients have been willing to enter in to such

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	an agreement. The buy-side of the market for audit has not been willing or able to enter into Liability Limitation Agreements.
59	The opening sentence on the banking crisis is highly questionable. The FRC's Public Oversight Board annual report to the Secretary of State found that audit was fundamentally sound[1] in the light of the banking crisis albeit that there is clearly a legitimate debate about whether the scope of statutory audit was still appropriate and what lessons can be learned, there is little debate that auditors did the current job correctly. This paragraph does not pick up all the issues surrounding reporting in relation to going concern issues. Debate was initiated and conducted by the independent Financial Reporting Council, and the proposals are contained in the Final Report and Recommendations of the Sharman Inquiry – "Going Concern and Liquidity Risks: Lessons for companies and auditors" published in July 2012 and the FRC's April 2012 consultations on its proposed revisions to the UK Corporate Governance Code and International Standards on Auditing (UK and Ireland) to give effect to its Effective Company Stewardship proposals. For the avoidance of doubt, the current system of accounts and audit report disclosure does not aim, as an end in itself, at predicting the company's future health, eg as to whether it could soon be in need of rescue. Rather, it has the aim of deciding whether the company no longer has a realistic alternative to an insolvency procedure, because, in such a case, the actual figures in the accounts must be changed to the fundamentally different break-up (fire sale) basis. Disclosures in accounts and emphasis-of-matter by auditors in their reports – which are not qualifications of the reports – aim only at informing shareholders about the directors' decision, with reasons, that there is a realistic scenario in which the company survives. This is the case even if the realistic scenario is one in which the company will be rescued. Furthermore, if there is no material uncertainty over the availability of a rescue, then auditing standards do not require any reporting from the auditor.
60	The European Parliament and European Council are currently debating the draft Directive and Regulation arising from the European Commission Green Paper "Audit policy – lessons from the crisis". When the result of these debates is known it will be possible to update this paragraph to set out the final outcome. The WP should mention that in the UK the FRC has, with the support of the Government, taken the debate on by its consultation papers under the "Effective Company Stewardship" heading on possible improvements to corporate reporting, audit and the audit report.

[1] FRC Professional Oversight Board Report to the Secretary of State, March 2009, p3 http://www.official-documents.gov.uk/document/hc0809/hc08/0875/0875.pdf