



Response to Working Paper 1: Law and Regulation

8th May 2012

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RESPONSE TO WORKING PAPER 1: LAW AND REGULATION

1. INTRODUCTION

1.1 Deloitte is grateful for the opportunity to comment on the first Working Paper published by the Competition Commission (**CC**). The Working Paper provides a valuable guide to the main legal and regulatory forces relevant to the audit of large companies in the UK.

1.2 However, the Working Paper contains insufficient discussion on one key issue: audit quality. The Working Paper sets out a definition and understanding of audit quality that is implausibly thin and fails to capture many of the factors that are regarded as central to the concept by market participants, regulators and commentators. We address this in detail in Section A of this response.

1.3 There are a small number of other very important issues which are raised by the Working Paper that Deloitte believes need further consideration by the CC. These are:

- (a) risk and liability;
- (b) the role of the audit committee;
- (c) US regulatory forces; and
- (d) regulation and market distortion.

We address these in Section B of the paper and include at **Annex 1** to this response suggested revised text, where applicable.

1.4 In **Annex 2** to this response, we separately set out a number of points of detail which may be of assistance to the CC.

SECTION A: AUDIT QUALITY

2. THE CONCEPT OF AUDIT QUALITY

2.1 Section Four of the Working Paper is entitled “The definition and regulation of audit quality”. We comment on each of these two elements in turn.

The definition of audit quality

2.2 The Working Paper sets out a well-known definition of audit quality from a 1981 paper by DeAngelo¹. The definition, though, fails to capture many of the key elements of audit quality: it does not capture factors which an empirical analysis of company and stakeholder requirements for the delivery of audit quality would include.

2.3 Support for a broader concept of audit quality is clearly evident in more recent and more empirically-based sources in the literature², and also in market practice. The CC will want to ensure that its understanding of audit quality is well-grounded in actual market practice before making any assessment of the role of audit quality in the competitive dynamics of the reference market.

The definition of audit quality in the academic literature

2.4 The academic literature supports a broader understanding of audit quality than that set out in DeAngelo's 1981 paper.

2.5 This is particularly evident from the 2004 study conducted for the Institute of Chartered Accountants of Scotland³. This comprehensive study is based on empirical evidence from the UK audit market⁴. Salient points arising from this study include the following:

- (a) there is an extensive body of literature surveying audit quality from an empirical or behavioural perspective; some of the most relevant papers are further described below;
- (b) the study recognises that the elements of audit quality may fall into two loose groupings – technical quality (such as expertise) and service quality (such as responsiveness and client service) – but it explains that there are important links between those elements in each group: “although technical quality and service quality emerge as distinct constructs, it is important to understand that significant relationships exist between those dimensions that make up those constructs”⁵;

¹ Paragraph 4.2 of the Working Paper. See DeAngelo, L.E., “Auditor size and audit quality”, *Journal of Accounting and Economics*, 3(3): 93-199 (1981).

² We note that the Working Paper was published shortly prior to Professor Beattie's “Initial review of relevant academic literature” (the *Literature Review*), and the CC will no doubt wish to ensure that subsequent commentary on the issues covered in the Working Paper fully captures the views and evidence set out in the literature referred to in the Literature Review.

³ Duff, “Auditqual: dimensions of audit quality”, 2004 (the *ICAS Paper*). This study is referenced in the Literature Review.

⁴ The study covered a sample of UK listed companies, so included, but was not limited to, the reference market.

⁵ Page 79 of the ICAS Paper.

- (c) each constituency surveyed (CFOs, audit partners and investor representatives) attached significance to a wide range of factors across these categories⁶;
- (d) while investor representatives tended to rate service quality issues slightly less highly than did other constituencies, they still attributed significant value to these attributes⁷; and
- (e) the study specifically notes that “the DeAngelo definition limits itself to a technical definition of audit quality” only⁸.

2.6 As noted above, there are many other studies which empirically examine stakeholders’ views of what constitutes audit quality. These include:

- (a) Beattie, Fearnley & Hines (2010)⁹: the most important factor in audit quality is communication between the auditor and the audit committee;
- (b) Beattie and Fearnley (1995)¹⁰: the five most important factors in audit quality are found to be:
 - (i) integrity of the audit firm;
 - (ii) technical competence of the audit firm;
 - (iii) the quality of the working relationship with the audit partner;
 - (iv) the reputation of the firm; and
 - (v) the technical competence of the audit partner; and
- (c) Carcello *et al* (1992)¹¹: the five most important factors in audit quality are found to be:
 - (i) team experience with the client;
 - (ii) industry expertise;

⁶ Page 105 of the ICAS Paper.

⁷ Ibid.

⁸ Page 2 of the ICAS Paper.

⁹ Beattie, Fearnley and Hines, “Factors affecting audit quality in the post-SOX UK regulatory environment: perceptions of chief financial officers, audit committee chairs and audit engagement partners”, 2010.

¹⁰ Beattie and Fearnley, “The importance of audit firm characteristics and the drivers of auditor change in UK listed companies”, *Accounting and Business Research*, Volume 25, pp.227-239.

¹¹ Carcello, Hermanson and McGrath, “Audit quality attributes: the perceptions of audit partners, preparers and financial statement users”, *Auditing: A Journal of Practice and Theory*, Volume 11 (1), pp.1-5.

- (iii) an audit team that operates to high ethical standards;
- (iv) a partner knowledgeable about the client's industry; and
- (v) frequent communication between auditors and management.

Further relevant studies are cited in the ICAS Paper and in the Literature Review.

The definition of audit quality in the market

2.7 This broader understanding of audit quality is similarly supported by market participants, including regulators and company stakeholders. The Working Paper notes, for example, the FRC's Audit Quality Framework, which sets out the multiple factors within the concept of audit quality. The FRC considers that the factors it identifies "determine whether a quality audit is undertaken"¹².

2.8 Further commentary from regulatory bodies underlines the multiple dimensions of high quality audit:

- (a) US Government Accountability Office: "Audit quality is often thought to include the experience and technical capability of the auditing firm partners and staff, the capability to efficiently respond to a client's needs, and the ability and willingness to appropriately identify and surface material reporting issues in financial reports."¹³
- (b) FRC: "A relationship built on trust and openness between the executive management of a company and its auditor contributes to an effective audit."¹⁴
- (c) FRC: "Audit quality is not driven by auditors alone. Auditors report on the financial statements which have been prepared under particular accounting standards. Those accounting standards should facilitate the production of an accurate picture of the company's financial health. If they do not, auditors cannot be expected to rectify such deficiencies."¹⁵
- (d) FRC: "The role of the audit committee in providing a conduit for the external auditor to communicate freely and openly is crucial to improving audit quality overall."¹⁶

¹² FRC, "Promoting Audit Quality", November 2006.

¹³ GAO, "Audit of public companies: continued concentration in audit market for large public companies does not call for immediate action", Report to Congress, January 2008, page 89.

¹⁴ FRC, "Promoting Audit Quality", November 2006.

¹⁵ FRC, Evidence to the House of Lords Economic Affairs Committee, September 2010.

¹⁶ FRC, "Walking the line: discussions and insights with leading audit committee members", February 2012.

2.9 This is supported by market stakeholders, as will be evident from the empirical studies cited above. It is also apparent from evidence provided to the CC's investigation:

- (a) Hermes: "The value of the audit to investors was more about the enhancement of the company's reporting over the year than the year-end sign-off."¹⁷
- (b) Hermes: "The best auditors succeeded in forming a good relationship with management and yet still challenged and changed accounting judgements where necessary."¹⁸
- (c) Baker Tilly: "An audit has two essential features: a monitoring feature and an advisory one (which firms often refer to as adding value to the audit, perhaps in terms of benchmarking corporate performance against competitors or providing a risk analysis service)."¹⁹

The CC will note that investors share the understanding that a high quality audit is built on many factors including service quality, which is value-enhancing for the company and its shareholders.

The regulation of audit quality

2.10 It is important to understand that the regulatory provisions relating to audit quality merely set a baseline for audit provision²⁰. They do not set out the standard which reference market companies and their stakeholders expect auditors to meet, and they do not capture all the dimensions of audit quality that are important to reference market companies and their stakeholders²¹.

2.11 This is widely recognised by industry bodies and market participants:

- (a) ICAEW: "The application of standards is taken to be a necessary but not a sufficient condition for achieving audit quality."²²

¹⁷ Hermes, Summary of meeting with the Competition Commission of 15 March 2012, paragraph 16.

¹⁸ Ibid, paragraph 20.

¹⁹ Baker Tilley, written evidence to the House of Lords Economic Affairs Committee.

²⁰ We note in this respect the recent academic work of Beattie, Fearnley and Hines which concludes that the regulatory processes put in place through the AIU have "reduced drastically the scope for poor quality audit", which is entirely consistent with Deloitte's view that regulation operates as a baseline standard. See Beattie, Fearnley and Hines, "Reaching key financial reporting decisions: how directors and auditors interact", ICAEW, 2011 (page 10).

²¹ For completeness, it should also be noted that regulatory standards do not exist, as the Working Paper suggests, to "reduce uncertainty regarding what amounts to a high-quality audit" (paragraph 4.8 of the Working Paper). As explained in this paragraph, they exist to set certain baseline standards.

²² See ICAEW, "Audit quality: challenges for international consistency", June 2010.

- (b) ICAEW: “Auditing standards are no substitute for the exercise of audit judgement, which is where mistakes are made.”²³
- (c) Hermes: “While there are detailed and specific standards...these are a minimum threshold.”²⁴
- (d) Hermes: “Regulation should be seen as a minimum requirement.”²⁵

2.12 The CC will note that the evidence in this respect refutes the (essentially unevidenced) contention in the OFT’s reference decision²⁶ that the extent of regulation may leave little scope for competition on quality. As Deloitte has explained²⁷, there is very strong competition on the basis of quality between different providers. Deloitte’s corporate strategy is explicitly based on the vision of being the “distinctive firm” in its delivery of quality across all its service lines and relationships, including with respect to audit²⁸. Deloitte’s very significant investments in audit quality – including its new audit methodology and software²⁹ – provide further evidence of this quality competition.

Conclusion

2.13 The concept of audit quality set out in the Working Paper needs further consideration and analysis by the CC. It may be that the CC plans to publish a further working paper addressing audit quality specifically, and capturing more fully the totality of the literature, and, in particular, the views of market participants; Deloitte would welcome this. Deloitte would be happy to discuss further with the CC how the CC can reach a fully informed understanding of audit quality.

SECTION B: OTHER ISSUES

3. THE ROLE OF THE AUDIT COMMITTEE

3.1 The Working Paper sets out at Section 6 many of the regulatory provisions relating to the operation of the audit committee of companies in the reference market.

²³ See ICAEW, “Audit quality: Fundamentals – principles-based auditing standards”, July 2006.

²⁴ Hermes, Response to the Issues Statement, page 2.

²⁵ Hermes, Summary of meeting with the Competition Commission of 15 March 2012, paragraph 25.

²⁶ See paragraph 5.13 of the OFT’s Market Investigation Reference decision.

²⁷ See paragraph 2.24 of Deloitte’s Summary Paper.

²⁸ See Deloitte’s Annual Report 2011, page 3.

²⁹ See further paragraph 2.12 of Deloitte’s Summary Paper.

FRC proposals for the enhancement of the audit committee's role and audit committee disclosure

3.2 The CC will wish to note the proposals recently published by the FRC to enhance:

- (a) the auditor's engagement with audit committees;
- (b) the role of audit committees; and
- (c) disclosure by audit committees of the assessments they have made.

3.3 Full details can be found on the FRC's website³⁰, but we set out the key proposals below³¹:

- (a) the audit committee should report to the board on the reasons why the annual report should be considered to be fair, balanced and understandable;
- (b) the audit committee should report to the board on the effectiveness of the audit process;
- (c) the audit committee should report to the board on its recommendation on the appointment of the auditor, including the steps taken in deciding whether or not to recommend that the audit be put out to tender;
- (d) the audit committee should report to the board on significant financial reporting issues and judgments made in the preparation of the financial statements, having regard to its communications with the auditor;
- (e) the audit committee should assess and report to the board on the qualification, expertise, resources and independence of the company's auditors and the effectiveness of the audit process;
- (f) FTSE 350 companies should put their audit out to tender at least once every ten years (on a comply or explain basis);
- (g) shareholders should be advised on when the company intends to put the audit out to tender, and an announcement of the intention to do so should be included in the previous year's annual report;
- (h) companies should disclose in their annual report the tenure of the current auditor and when they last put the audit out to tender;
- (i) the audit committee section of the annual report should explain the approach to the appointment or reappointment of the auditor, including

³⁰ See <http://www.frc.org.uk/press/pub2764.html>.

³¹ Suggested revised text is included at **Annex 1**.

the steps taken in deciding whether or not to recommend that the audit be put out to tender;

- (j) the audit committee section of the annual report should explain why the company did or did not put the audit out to tender and why the company chose to reappoint or change the auditor;
- (k) the audit committee section of the annual report should set out any contractual obligations that limit the audit committee's choice of auditor;
- (l) the audit committee section of the annual report should set out significant issues considered by the audit committee in relation to the financial statements and how these were addressed, having regard to its communications with the auditor;
- (m) the audit committee section of the annual report should set out an assessment of the effectiveness of the audit process; and
- (n) if the auditor provides any non-audit services, the audit committee section of the annual report should set out how auditor objectiveness and independence is safeguarded.

3.4 We note the evidence of the ABI to the CC's investigation that this initiative is an important mechanism for addressing concerns about potential information asymmetry concerns with respect to audit³².

The historic enhancement of the audit committee's role and engagement between the audit committee and the auditor

3.5 The Working Paper notes in Section 6 and in Annex B the enhancement of the role of the audit committee over time (a process which continues in the latest FRC proposals). The CC will note the widespread acknowledgement that this has led to much greater engagement between the auditor and the audit committee, leading to significantly enhanced ability of the audit committee to assess the quality of the audit that has been delivered. It is simply no longer possible to say that the quality of the audit is invisible to the audit committee (who are, it should be noted, the guardians of shareholders' interests in this respect).

3.6 Strong support for this is found both in the academic literature and in market commentary. In particular:

- (a) within the literature, the CC will note:
 - (i) Beattie, Fearnley and Hines (2011)³³: this very recent empirical study finds that "audit committee chairs are fully engaged with

³² See the ABI's Response to the Issues Statement, paragraph 8.

³³ Beattie, Fearnley and Hines, "Reaching key financial reporting decisions: how directors and auditors interact", ICAEW, 2011.

the financial reporting process”³⁴ and that corporate governance changes “have changed the power relations between the key parties: the audit committee chair (and audit committee) have gained power on accounting matters at the expense of the CFO and audit engagement partner”³⁵; and

- (ii) Beasley, Carcello, Hermanson and Neal (2009)³⁶: this slightly older study in a US context found that “the external auditor is heavily involved in audit committee meetings” and that “there often is significant contact between the audit committee chair and the auditor outside of meetings”.

(b) the CC will also note the following evidence:

- (i) BDO/ICAEW: “In recent years the responsibilities of audit committees and the time commitment of non-executive directors who serve on them have increased greatly.”³⁷
- (ii) FRC: “Audit committees have wide-ranging, time-consuming and sometimes intensive work to do.”³⁸
- (iii) FRC: “A strong sentiment prevails among audit committee chairmen we interviewed: their role and responsibilities are well understood and there is a clear understanding of the leadership, knowledge and accountability needed to provide for their committees to operate effectively.”³⁹
- (iv) ACCA: “The audit committee is critical to ensuring the organisation has strong and effective processes relating to independence, internal control, risk management, compliance, ethics, and financial disclosures.”⁴⁰
- (v) ICAEW: “Audit committees have over the past 10 years assumed a far greater role in making sure that the choice of auditors is being exercised in a competitive and challenging way.”⁴¹

³⁴ Ibid, page 8.

³⁵ Ibid, page 9.

³⁶ Beasley, Carcello, Hermanson and Neal, “The audit committee oversight process”, Contemporary Accounting Research, Volume 26(1), 2009, pp65-122.

³⁷ BDO/ICAEW, “The buck stops here? New challenges for audit committees”, 2011.

³⁸ FRC, “Guidance for audit committees”, December 2010.

³⁹ Ibid.

⁴⁰ ACCA, written evidence to House of Lords Economic Affairs Committee.

⁴¹ ICAEW, evidence to House of Lords Economic Affairs Committee, 19 October 2010.

- (vi) Grant Thornton: “These issues are already the subject of thorough discussion with audit committees, for example judgments relating to the financial statements and risk of their misstatement. These discussions conventionally are of a private nature and held in confidence between the audit committee and the auditors. The discussions generally address the risks faced by the company and the judgments made by its management in preparing the financial statements.”⁴²

3.7 Deloitte has explained to the CC that it considers that the enhancements in the role of the audit committee of FTSE 350 (and other) companies over the past several years means that they now have a high level of visibility on the quality of the audit delivered by the auditor⁴³. This is strongly supported by the evidence set out above.

4. RISK AND LIABILITY

4.1 Paragraph 3.45 *et seq* of the Working Paper sets out the CC’s current understanding of the position with respect to auditor liability.

4.2 There are two important elements of the analysis set out in the Working Paper which we believe do not fully capture the true position:

- (a) the description of the “true and fair” principle; and
- (b) the description of auditors’ ability to limit their (otherwise unlimited) liability by contract.

4.3 First, the CC sets out various statements from the case law in relation to the “true and fair” principle, before concluding that “it therefore appears in practice that the phrase equates to being computed in accordance with the relevant accounting principles”⁴⁴.

4.4 This conclusion, and in particular, the word “computed” mischaracterises the “true and fair” concept, and, indeed the audit as a whole. The assessment of whether the accounts represent a “true and fair view” of the company’s affairs involves much more than a mechanical “computation”. It may, for example, require an assessment of whether additional information needs to be given in the company’s report, whether due prominence is given to particular information, whether further information needs to be provided in the notes to the accounts in order to give sufficient clarity. This requires a very full, judgment-led assessment process by the auditor.

⁴² Grant Thornton, Response to European Commission Green Paper (Audit policy – lessons from the crisis), 20 December 2010

⁴³ See Deloitte’s response to the Issues Statement, paragraph 2.5.

⁴⁴ Paragraph 3.53 of the Working Paper.

4.5 For summary purposes, we believe that a more accurate characterisation would be that “true and fair” equates to *an assessment of whether the financial statements have been prepared, taken as a whole, in line with relevant accounting principles*, but it is critical also to have a full understanding of the assessment process that lies behind this⁴⁵.

4.6 Second, the CC states in footnote 44 that “In principle, an auditor has unlimited liability, but under sections 532-538 of the [Companies] Act, auditors are able to limit liability by contract.”.

4.7 A more accurate description of the position would be that⁴⁶:

- (a) the auditor has unlimited liability;
- (b) in principle, the auditor is able to limit this liability by contract, pursuant to the Companies Act; but
- (c) in fact, companies in the reference market are highly resistant to this, such that there is no company in the reference market with which Deloitte has agreed any limitation to its liability.

4.8 The CC will be aware of the extensive literature on audit liability and how this is thought to incentivise high levels of audit quality⁴⁷, and clients’ position on contractual limitations to that liability may reflect that view⁴⁸.

5. THE IMPORTANCE OF US REGULATORY FORCES

5.1 The Working Paper appears not fully to capture the importance within the reference market of certain US regulatory provisions, deriving primarily from the Sarbanes-Oxley Act and related SEC rules on auditor independence.

5.2 The Working Paper briefly notes the introduction of these rules and that they “apply to many of the largest UK companies as they are listed in the US”⁴⁹. These are exclusively companies within the reference market. .

5.3 There are three important dimensions to the effect of Sarbanes-Oxley:

- (a) first, it increased the substantive complexity of the audit. We note in this respect the evidence that has been provided to the CC by Jeremy

⁴⁵ Suggested revised text is attached at **Annex 1**.

⁴⁶ Suggested revised text is attached at **Annex 1**.

⁴⁷ See, for example, Office of Fair Trading, “An assessment of the implications for competition on a cap on auditors’ liability”, July 2004, page 6.

⁴⁸ See, for example, the evidence of the ACCA to the House of Lords Economic Affairs Committee.

⁴⁹ Paragraph 5.101 of the Working Paper.

Schwartz, indicating that the Sarbanes-Oxley Act was a very significant driver of audit fee increases in the US⁵⁰;

- (b) second, it increased the extent of disclosures in company reporting, which required additional auditor input; and
- (c) third, it introduced stricter requirements for the independence of the company's audit committee and auditors (including a ban on the provision of certain non-audit services).

5.4 It should be noted that these rules also have a broader effect on standards applied by companies which are not listed in the US. It has been a major feature in raising the bar for regulation of the audit process in the UK.

6. REGULATION AND MARKET DISTORTION

6.1 The Working Paper makes clear the wide range of regulatory forces that act on the market for the audit of large companies in the UK. Importantly, the evidence set out in the Working Paper (combined with evidence from other readily-available sources) appears to indicate that concerns expressed in the Issues Statement in relation to the operation of regulation in the reference market are not well-founded.

6.2 This has three particular dimensions:

- (a) there is no evidence that regulation operates as a barrier to entry, operation or expansion in the reference market;
- (b) there is no evidence of influence by the largest audit firms over applicable regulatory standards; and
- (c) there is no evidence that regulation or enforcement of regulation otherwise "favours" the largest audit firms.

6.3 First, we note that that no market participants have expressed concern that the regulatory requirements described in the Working Paper form a barrier to entry, operation or expansion in the reference market – indeed, market participants have explicitly confirmed that this is not the case⁵¹. This is consistent with Deloitte's understanding of the operation of the market, as it explained in its response to the Issues Statement⁵².

⁵⁰ See Evans and Schwartz, "Was it market power or Sarbanes-Oxley? An analysis using the workhorse audit fee model and panel data techniques", October 2011.

⁵¹ See, in particular, Grant Thornton's Response to the Issues Statement, paragraph 10.1; and BDO's Response to the Issues Statement, paragraph 3.15.

⁵² See paragraph 7.15 of Deloitte's Response to the Issues Statement.

6.4 Second, there is no evidence in the Working Paper of heightened involvement of the largest audit firms in the formulation of these regulatory standards and requirements. The Working Paper notes, for example:

- (a) that the FRC is the industry's "independent regulator", which is not reliant on the industry for its funding⁵³; and
- (b) the proposals to increase the independence of the FRC⁵⁴.

6.5 The latter is an important point which is not fully captured in the Working Paper: the FRC has proactively identified that it needs to provide greater reassurance as to its independence from the industry that it regulates (including, but not limited to, the largest audit firms), and so is embarking on a process whereby that independence will be reinforced. This is directly contrary to any suggestion of regulatory capture.

6.6 It is worth setting out in this context Deloitte's observations in the context of the FRC/BIS consultation on the reform process:

"A further consequence of having all the major decisions made at the FRC Board level will be that it will be harder for all members of regulated auditors, not just the major firms, to be involved directly in standard setting. If current powers of the POB are transferred to the board of the FRC, it is difficult to see how it would be possible to appoint individuals from the regulated firms to the FRC Board... We concur that it is important to guard against regulatory capture and, while this concern is not mentioned directly in the proposals, it appears to be the basis for the FRC's desire for greater independence."⁵⁵

6.7 We also note the following comment from the Chair of the FRC to the House of Lords Economic Affairs Committee on this issue:

"On the issue of regulatory capture, I think the journey of travel at the FRC has been exactly in the opposite direction. That is to say, it was born out of a quasi self-regulatory system and over time, under Stephen and my predecessors, a greater degree of independence has been created in the structure."⁵⁶

6.8 There is thus strong evidence that regulatory capture via undue involvement of representatives of the largest audit firms (or indeed any other audit firms) in the regulatory process is not a feature of this market.

⁵³ Paragraph 5.7 of the Working Paper.

⁵⁴ Paragraph 5.80 of the Working Paper.

⁵⁵ Deloitte, Response to FRC/BIS consultation on FRC reform: see http://www.frc.org.uk/documents/pagemanager/frc/Reform/Comment_letters/Deloitte%20Response.pdf. In the context of this consultation, Deloitte (and others) observed that there continued to be benefits from engagement with market participants in the standard setting process.

⁵⁶ FRC, evidence to the House of Lords Economic Affairs Committee, 9 November 2010.

6.9 Third, there is no evidence that regulation or enforcement of regulation in practice favours the largest audit firms.

6.10 In fact, the evidence set out in the Working Paper shows that they face a tougher regime than smaller audit firms. In particular, they are subject to yearly assessment by the AIU, while mid-tier firms are assessed over a two-year period, and smaller firms are subject to a more discretionary assessment process⁵⁷.

7. CONCLUSION

7.1 The Working Paper provides a valuable guide to the main constituent parts of the legal and regulatory forces relevant to the audit to large companies in the UK.

7.2 The CC must, though, give further attention to the concept of audit quality, so as to capture fully all those factors which are considered central to audit quality by market participants, regulators and commentators.

7.3 Furthermore, in assessing how legal and regulatory forces impact competition in the reference market, the CC must be mindful of:

- (a) that audit committees have a strongly enhanced role nowadays and consequently much greater visibility on the quality of the audit provided to the company and its stakeholders;
- (b) that FRC proposals will substantially enhance that role and disclosure to investors;
- (c) that auditors' liability is in fact unlimited, which strongly incentivises them to pursue audit quality;
- (d) that the Sarbanes-Oxley Act is a major factor in the UK market as well as in the US; and
- (e) that the evidence shows that concerns in relation to the potential for a distortive effect of regulation in the market for audit of large companies in the UK are unfounded.

⁵⁷ See paragraph 5.38 of the Working Paper.

ANNEX 1

Paragraph 3.15

Under sections 532-538 of the Act, auditors are able to limit liability by contract to an amount that is “fair and reasonable in all the circumstances”. However, we understand that, in practice, such contractual limitations are very uncommon in the reference market. Where such an agreement is entered into, it must disclose, in a note to the accounts, the principal terms and the date of the approval resolution (or of the resolution waiving the need for approval, in the case of a private company) passed by the company’s members.

Paragraph 3.49

The leading case in relation to auditor duty of care is *Caparo Industries plc v. Dickman*⁵⁸. The case sets out the now well-established conditions that must be met for a duty of care to arise. The House of Lords concluded that the auditor’s statutory duty is owed to the shareholders as a body to exercise their class rights - sometimes referred to as their rights of stewardship - in general meeting (for example, whether to remove directors). The duty does not extend further unless the auditor in some way assumes a special duty to another party. The tests for determining whether a special duty has arisen, or whether the auditor has assumed a responsibility beyond the statutory duty, has been the subject of a number of cases since *Caparo*, and has been formulated in varying, but essentially consistent, ways. However, the underlying statutory duty remains clearly as stated in *Caparo*.

The implications of the case are well-summarised by Lord Phillips of Worth Maltravers as follows:

“The duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant Auditing Standards. The duties are duties of reasonable care in carrying out the audit of the company’s accounts. They are owed to the company in the interests of its shareholders. No duty is owed directly to the individual shareholders. This is because the shareholders’ interests are protected by the duty owed to the company. No duty is owed to creditors - *Al Saudi Banque v Clarke Pixley* [1990] Ch 313. The Auditing Standards require auditors who have reason to suspect that the directors of a company are behaving fraudulently to draw this to the attention of the proper authority.”

Paragraph 3.53

⁵⁸ [1990] UKHL 2

It therefore appears in practice that the phrase equates to the accounts, taken as a whole, being prepared accordance with the relevant accounting principles. The FRC, through the Accounting Standards Board, develops and publishes principles by which accounting standards can be established, and to provide a framework within which accounting issues can be resolved. Assessment of whether the accounts present a “true and fair” picture may commonly involve the exercise of the auditor’s judgment.

Paragraph 5.60

The AADB is currently investigating 18 cases (of which three relate to individual conduct and 15 to firm conduct), dating back to 2005 in the case of the MG Rover/Deloitte case. Of the 15 extant cases, five relate to the reference market. The three most recent cases (not all in the reference market) involve Healthcare Locums plc (audited by BDO), Aero Inventory plc (audited by Deloitte) and Connaught plc (audited by PwC). The scope of each of these investigations relates to the audit of the financial statements for various years. In some (less recent) cases the scope of the investigation was limited to particular audit matters, for example commissions paid, revenue recognition, or goodwill, or work done supporting reports to the FSA on compliance with client assets

Footnote 126

MG Rover went into administration in 2005, and subsequent investigations criticized the five executives who oversaw the company’s collapse, four of whom were disqualified from serving as company directors. In August 2005, the AADB announced that it was going to review Deloitte’s conduct as auditors and advisers to various companies in the MG Rover Group sale. The Executive Counsel announced the outcome of that investigation and filed complaints on 2 February 2012. Both the AADB and Deloitte confirmed that the inquiry relates to the ‘transactions’ overseen by Deloitte, not the audit work.

Paragraph 6.12

The FRC has recently published proposals for the enhancement of the role of the audit committee and disclosure by the audit committee. The FRC is currently consulting on these proposals⁵⁹.

The main elements of the proposals with regard to audit committees are as follows:

⁵⁹ FRC, “Revisions to the UK Corporate Governance Code and Guidance on Audit Committees”, April 2012.

- (a) the audit committee should report to the board on the reasons why the annual report should be considered to be fair, balanced and understandable;
- (b) the audit committee should report to the board on the effectiveness of the audit process;
- (c) the audit committee should report to the board on its recommendation on the appointment of the auditor, including the steps taken in deciding whether or not to recommend that the audit be put out to tender;
- (d) the audit committee should report to the board on significant financial reporting issues and judgments made in the preparation of the financial statements, having regard to its communications with the auditor;
- (e) the audit committee should assess and report to the board on the qualification, expertise, resources and independence of the company's auditors and the effectiveness of the audit process;
- (f) FTSE 350 companies should put their audit out to tender at least once every ten years (on a comply or explain basis);
- (g) shareholders should be advised on when the company intends to put the audit out to tender, and an announcement of the intention to do so should be included in the previous year's annual report;
- (h) companies should disclose in their annual report the tenure of the current auditor and when they last put the audit out to tender;
- (i) the audit committee section of the annual report should explain the approach to the appointment or reappointment of the auditor, including the steps taken in deciding whether or not to recommend that the audit be put out to tender;
- (j) the audit committee section of the annual report should explain why the company did or did not put the audit out to tender and why the company chose to reappoint or change the auditor;
- (k) the audit committee section of the annual report should set out any contractual obligations that limit the audit committee's choice of auditor;
- (l) the audit committee section of the annual report should set out significant issues considered by the audit committee in relation to the financial statements and how these were addressed, having regard to its communications with the auditor;
- (m) the audit committee section of the annual report should set out an assessment of the effectiveness of the audit process; and

- (n) if the auditor provides any non-audit services, the audit committee section of the annual report should set out how auditor objectiveness and independence is safeguarded.

Further detail on the evolution of UK corporate governance is contained in Annex B.

ANNEX 2

These points of detail are also captured, where applicable, in the suggested revised text in **Annex 1**.

Paragraph	Comment
3.42 <i>et seq</i>	<p>The Working Paper sets out various case law relating to auditor liability. Two of the extracts mention the leading case in this area, <i>Caparo Industries plc v. Dickman</i>, but it is not addressed directly or in detail. The CC may wish to consider giving this a more central place in its analysis of auditor liability. We include some further details in suggested revised text at Annex 1.</p> <p>The CC may also find it helpful to refer to ISA 240 and ISA 500 in the context of auditors' duties and liabilities.</p>
4.33	<p>The rules included in the Act stem from the Statutory Audit Directive. There could also be reference to the requirement in the Audit Regulations (including 3.02, 3.05 and 3.20 and Guidance Chapter 1) to be "fit and proper" and for each partner (whether an audit partner or not) to be so.</p>
4.60	<p>This paragraph should also mention that "key partners in the audit" also must rotate every seven years, which includes divisional partners.</p>
4.8	<p>The CC may also wish to reference International Standard on Quality Control 1.</p>
5.7 <i>et seq</i>	<p>The Working Paper sets out the structure of the FRC in Figure 1. In fact, the FRC has already embarked on the process of reform which the CC notes in paragraphs 5.79 <i>et seq</i>, with implications for its structure.</p>
5.60	<p>The Working Paper states that the AADB is investigating 18 cases at present. In fact, three of these relate to individuals, rather than audit firms.</p> <p>Furthermore, only five relate to audit activities within the reference market:</p> <ul style="list-style-type: none"> • Barclays Capital Securities Limited (via its FTSE 100 parent company) • Connaught plc

	<ul style="list-style-type: none"> • iSoft Group plc • BAE Systems • Cattles plc <p>We further understand that the iSoft Group plc investigation has been closed, but that the findings are not yet published pending the conclusion of criminal proceedings.</p> <p>In relation to MG Rover, the investigation by the AADB was announced on 17 August 2005. The Executive Counsel announced the outcome of that investigation and filed complaints on 2 February 2012. As the Working Paper notes, those complaints do not concern Deloitte’s statutory audit work (or audit related services).</p>
Section 5	<p>The CC may also wish to consider the Audit Firm Governance Code, drawn up by the ICAEW at the invitation of the FRC.</p> <p>Details can be found at: http://www.icaew.com/en/products/governance/~media/36CB4126D9C145BE86CADFB4EA1B5903.ashx</p>