

**UK GOVERNMENT RESPONSE**

European Commission's Green Paper on  
Audit

DECEMBER 2010

## **UK Government Response to the European Commission's Green Paper on Audit 8 December 2010**

### **INTRODUCTION**

#### **1. General remarks on approach of Green Paper?**

The Government welcomes the opportunity to respond to the Green Paper. In the UK, the issue of audit has attracted significant interest. Apart from the House of Commons Treasury Select Committee, quoted in the Green Paper, we would like to draw the Commission's attention to the Financial Reporting Council and the Financial Services Authority's publication of a Discussion Paper<sup>1</sup> on "Enhancing the auditor's contribution to prudential regulation" in 2010; the Institute of Chartered Accountants in England and Wales' publication of *Audit of Banks: Lessons from the Crisis* in 2010<sup>2</sup>; and the House of Lords Economic Affairs Committee's inquiry into audit, which is being conducted in the fourth quarter of 2010, and which is expected to report in the Spring of 2011. (See Q2,3,17,26). The Government's own Memorandum of Evidence submitted to the House of Lords inquiry is attached to this document as an Appendix.

We welcome the Commission's commitment to better regulation principles, as it is vital that any changes to audit regulation at EU or Member State levels are evidenced by an assessment of the economic impacts which demonstrates that the benefits exceed the costs.

#### **2 Is there a need to better set out the societal role of the audit with regard to the veracity of financial statements?**

The Government's view is that audit has an important role to play in ensuring vibrant capital markets, and its importance is as one element in a multi-faceted regime of corporate governance and regulation. There are other elements available for regulators, companies and investors as an additional support or substitute for audit and vice versa. These include accounting standards, dispersed ownership, risk management committees, audit committees<sup>3</sup>, internal auditors, credit ratings, insurance markets, investment analysts, or additional disclosures above those mandated by accounting standards and the law, and regulatory and supervisory bodies.

As already recognised by the Commission in EU law, the benefits of audit vary according to company size so, although the Green Paper asserts that audit reduces the cost of capital for companies, it is not surprising that the Government has not found unambiguous evidence that mandatory audit

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<sup>1</sup> FRC FSA Discussion Paper: Enhancing the auditor's contribution to prudential regulation (June 2010) <http://www.frc.org.uk/publications>

<sup>2</sup> ICAEW Financial Services Faculty: *Audit of Banks: Lessons from the Crisis*, (part of the Inspiring confidence in financial services programme) April 2010

<sup>3</sup> Carcello J. and Neal T., *Audit committee characteristics and auditor dismissals following "new" going-concern reports*, *The Accounting Review* Vol 78, No.1, January 2003 pp 95-117

decreases the cost of capital across the whole economy. But what the evidence does show is that where a company has an audit voluntarily, (a) it does benefit from a reduction in its cost of capital because of the signalling effect of audit, and (b) the bigger the company, the more likely it is to have a voluntary audit. This implies that the bigger the company, the more valuable it finds the audit process.

Also the role of audit need not be exactly the same in all sectors of the economy. For example, given the importance of key financial institutions to the economy, the Government sees a clear need for auditors to contribute to prudential supervision (see Q1,3,17,26).

### **3. Could the general level of “audit quality” be further enhanced?**

It is clearly desirable to enhance audit quality (i.e. to ensure that current procedures are followed to a higher standard). This may be enhanced by improving auditor scepticism (Q6) and, in relation to listed companies, by enhancing the content of the report of the audit committee (Q8). It can also be enhanced by exposing the expectation gap (see Q 5). However, the Government is inclined to be cautious about any proposals to add to the scope of audit in relation to published accounts, in the absence of a robust assessment of the economic impacts, in line with the Commission’s commitment to better regulation.

There are also clear benefits to be achieved in enhancing the role of assurance in prudential supervision of financial institutions, e.g. by enhancing the interaction between auditors and supervisors, and this is already being investigated in the UK. (See Q1,2,17,26)

## **COMMUNICATION BY AUDITORS TO STAKEHOLDERS**

### **4. Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for purpose?**

Audit already does provide comfort on the financial health of companies as one element in a regime of corporate governance. There are other elements which also provide comfort on the financial health of companies available for regulators, companies and investors, as set out in our response to Q2.

It is clear that there has been an expectation gap in as much as the audit is often assumed to provide a greater degree of assurance than any system can actually provide.

The expectation gap has been well known for 50 years. Over that time attempts have been made to reduce it both by increasing the quality of audit through interventions such as audit inspections, auditing standards and professional education, and publicising the limits of the audit by amendments to the audit report requirements.

The Government's view is that information about the company-specific issues such as the degree of aggression in the company's accounting choices, the risk position of the company and the key judgements taken during the course of the audit might be best disclosed in the report of the audit committee. The audit committee could be required to give a view as to the extent to which and how Directors have complied with accounting standards in arriving at a true and fair view. The audit committee could explain the processes and reasons for auditor (re)appointment. Whilst seeking an expanded audit committee report, it is important to note that the audit committee is a sub-committee of the Board and that relationship of Board responsibility needs to be maintained.

The Government agrees on the importance of users understanding what auditors do. The sources of information available to users are:

- the report and accounts of the company
- disclosure by the directors of discussions that they have had with auditors
- information directly from the auditors, such as their audit report, or their statement on ceasing to hold office. This statement has a longstanding role in UK law (beyond that required by Article 38.2 of the Statutory Audit Directive). This involves the provision of information to shareholders and the possibility of discussing the circumstances connected with the auditor's departure at a general meeting.

**5. To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?**

Auditing theory<sup>4</sup> suggests that audit works best in normal environments – that is, in non-collapsing systems and non-fraudulent firms – where auditors can expect that normal audit procedures will uncover normal errors and normal managerial misstatements. This suggests that audit is unlikely to provide a defence against systemic risk in an economy. Audit also provides only a limited defence against material fraud in a company, especially where there is significant collusion by senior management. These issues can give rise to the expectation gap, where people expect to get more assurance out of an audit than is in reality provided, or can be provided.

The suggestion is in response to Q4 and will help to bridge the expectation gap but it is unlikely that it can ever be closed entirely (see response to Q3 above).

**6. Should “professional scepticism” be reinforced? How could this be achieved?**

Professional scepticism is key to maximising the usefulness of audit, and is an issue for auditors worldwide. In the US, research<sup>5</sup> has shown that the failure to demonstrate an appropriate level of scepticism was a deficiency found in 60% of the cases where the SEC brought fraud related actions against

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<sup>4</sup> Mautz and Sharaf *Philosophy of Auditing*, (American Accounting Association)1961

<sup>5</sup> M.S. Beasley, J.V. Carcello & D.R. Hermanson, 2001 Top 10 audit deficiencies. *Journal of Accountancy* 191 (4): 63-66

auditors. The UK's Audit Inspection Unit in their 2009/10 Annual Report<sup>6</sup> reported that audit firms are not always applying sufficient professional scepticism in relation to key audit judgements. This has prompted UK regulators to examine this issue carefully.

As a result, the UK Auditing Practices Board published a Discussion Paper in August 2010 on this issue, entitled "Auditor scepticism: raising the bar."<sup>7</sup> This is probably best effected via ethical guidelines and the UK will continue to move forward with this work.

### **7. Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?**

Reporting<sup>8</sup> systems in other fields, in health and safety for example, have more finely-tuned and graduated forms of reporting and adverse reporting is normalised to a certain extent. The lack of such a "graduated ladder" of reporting options is one source of difficulty for auditors.

The Government supports an alternative approach to making changes to the audit report: increased disclosure by the directors. This has already been successfully put in practice in the UK. An example of this is the guidance on Going Concern which was issued in 2009 by the Financial Reporting Council<sup>9</sup>. This guidance resulted in additional information being provided to users of the accounts by directors. The going concern assessments are considered by the auditors in coming to their opinion on the financial statements. This sort of additional disclosure could avoid the need for a graduated form of audit report.

Another source of increased disclosure that the Government favours is through extensions to the report of the audit committee (see Q8), which could be done on a voluntary basis.

### **8. What additional information should be provided to external stakeholders and how?**

See Q . 5 for the possible contribution of the audit committee report.

The audit committee could also explain the processes and reasons for auditor (re)appointment. The Government is open to the possibility of requiring the auditors providing some form of assurance or corroboration over the information in the audit committee report.

This approach is currently being investigated in the UK and could avoid the risk of boilerplate, which is a likely response to any enhancement of the contents of the audit report.

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<sup>6</sup> Audit Inspection Unit Annual Report 2009-10 (21 July 2010) Financial Reporting Council <http://www.frc.org.uk/pob/audit/reports.cfm>

<sup>7</sup> Auditing Practices Board: *Auditor scepticism: raising the bar* (August 2010) Financial Reporting Council <http://www.frc.org.uk/apb/publications/pub2343.html>

<sup>8</sup> Power M (1999) *The Audit Society: Rituals of Verification*, Oxford University Press, Oxford

<sup>9</sup> <http://www.frc.org.uk/publications/pub2140.html>

Audit committees could also be asked to indicate (a) the length of time that the current auditor has been in office; (b) their reasons for recommending the current auditor for reappointment as opposed to a decision to retender; and (c) in the event of a retender, the reasons for making the subsequent appointment.

There are clearly costs associated with the various routes, and it may be hard swiftly to achieve the benefits desired, but subject to the Commission's assessment of the impacts, we believe that, of the options available, additional disclosure by the directors in the report of the audit committee is likely to be the most successful route to follow.

**9. Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can communication be improved?**

Current arrangements in the UK should already provide for adequate and regular dialogue between these bodies.

**10. Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?**

We are not yet convinced what role, if any, the auditor should play in the field of CSR but are open to further examination of this issue.

The Government has recently consulted on the narrative reporting framework with the objective of driving up the quality of reporting to the standard of the best including on social and environmental matters. We are currently analysing the responses but a first review suggests that, while some respondents saw some merit in exploring a proportionate level of independent assurance of narrative information in reports, including the CSR elements, some also cautioned that this would be difficult in practice and could lead to unintended consequences by encouraging more boilerplate reporting. The Government will want to consider the responses to its consultation in detail before reaching any conclusions on the value of audit in this area but would note that more detailed consideration would need to be given to the potential impacts if this were to be pursued.

**11. Should there be more regular communication by the auditor to stakeholders? Also should the time gap between the year end and the date of the audit opinion be reduced?**

Our view is that the most appropriate way for investors and other stakeholders to further improve the information flow about the audit is through an enhanced audit committee report, as described above in Q8.

Apart from providing the audit report, and their regular meetings with the audit committee, auditors have the right under UK company law to attend and be heard at general meetings of the company and, on resignation may (or for quoted companies must) make a written statement<sup>10</sup> to the company, which is required to be circulated to the shareholders and the regulators. This predates, and is in addition to, the UK's implementation of the provisions of the EU Statutory Audit Directive<sup>11</sup>. Thus the UK considers that there are already well established channels of communication between auditors and shareholders in these circumstances.

Companies are capable of very fast year end closes, which has the advantage of providing markets with more timely information<sup>12</sup>, suggesting there may be scope for reducing the time gap, particularly for listed financial institutions, between the year end and date of the audit opinion. However this should only be pursued if there was no risk of audit quality suffering, as most UK listed companies have the same, 31 December year end and might therefore either risk reducing audit quality or increasing audit fees.

**12. What other measures could be envisaged to enhance the value of audits?**

It is vital that any changes to audit regulation at EU or Member State levels are evidenced by an assessment of the economic impacts which demonstrates that the benefits exceed the costs.

**ISAs**

**13. What are your views on the introduction of ISAs in the EU?**

The UK has updated its auditing standards to align with the new clarified ISAs, and the new UK auditing standards will be effective for audits of financial statements for years ending after 15 December 2010.

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<sup>10</sup> Companies Act 2006 s518-519

<sup>11</sup> Art 38 Statutory Audit Directive (2006/43/EC)

<sup>12</sup> BPM Close Cycle Rankings 2010 <http://www.bpm-international.com/close.html>

**14. Should ISA's be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing for the endorsement of International Financial reporting Standards (IFRS)? Alternatively, and given the current widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?**

Since the use of ISAs is currently widespread in the EU, if there were perceived to be a need for an EU endorsement process, we favour encouraging the use of ISAs by non-binding legal instruments to avoid imposing new regulatory burdens.

**15. Should ISAs be further adapted to meet the needs of SMEs and SMPs?**

If, as a result of changes at EU level, more SMEs could be exempted from audit, there would be little need for adaptation. If there is not such an increase in the exemption thresholds, then the Government perceives a need for a simpler approach for SMEs.

## **GOVERNANCE AND INDEPENDENCE OF AUDIT FIRMS**

**16. Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?**

In the UK the auditor is not appointed by the audited entity itself, but by the shareholders of the audited entity. In our view there is no evidence of systematic problems of auditor independence, but the body best placed to preserve auditor independence in public interest entities is a strong audit committee.

**17. Would the appointment by a third party be justified in certain cases?**

The primary responsibility for appointing auditors should continue to rest with the shareholders of the company.

If the Commission's analysis of the costs and the benefits showed it would be appropriate, we would not be opposed to regulators operating enhanced licensing systems which might include restrictions on firms or individuals who would be permitted to conduct public interest audits or the audits of banks, for example. (See Q1,2,3,26).

**18. Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?**

There are two possible grounds for investigating the time limitation of the audit appointment: (a) to promote auditor independence and/or (b) to achieve a reduction in market concentration.

We do not believe that there is a systematic problem with the independence of auditors and having reviewed the evidence on the effectiveness of rotation

there is no evidence that the existing system of partner rotation is failing to work in maintaining the independence of the auditor.

However, issues of rotation and compulsory tendering need to be examined in the context of remedying the current concentration in the audit market. See Q 29.

**19. Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?**

There have been major changes to the EU regulatory regime for non-audit services since the collapse of Enron in 2002. In the UK, requirements on auditor independence are now more explicit and there is greater disclosure and transparency. For directors, the Combined Code expects the company audit committee to engage with the decision to purchase non-audit services in the director's report published with its financial statements. This approach is designed to give investors information about what is being purchased. For auditors, the Auditing Practices Board Ethical Standard 5 (ES 5 ) sets out detailed caveats for the provision of specific non-audit services, which amount to a de facto prohibition in many cases, particularly for listed entities. This framework implements chapters 4 and 10 of the Statutory Audit Directive.

The Financial Reporting Council held a consultation earlier in 2010 about this issue. The overwhelming response from a range of investors, preparers and auditors, was against a ban on non-audit services. Such a ban has therefore not been introduced in the UK, and we would not support one.

The UK would be reluctant to support additional rules for the audit of financial institutions. There is no evidence that non-audit services were a factor in the financial crisis.

**20. Should the maximum level of fees an audit firm can receive from a single client be regulated?**

In the UK the Ethical Standards of the Auditing Practices Board set the maximum level of fees that an audit firm can receive from a single client. For listed companies this limit is 10% and for unlisted companies 15% of the overall fee income to their firm. This ensures the continuing independence of firms.

**21. Should new rules be introduced regarding the transparency of the financial statements of audit firms?**

In addition to the transparency reporting requirements of the Statutory Audit Directive, audit firms in the UK are already subject to the UK Audit profession's voluntary code of practice on disclosing audit profitability. In addition, audit firms established as limited liability partnerships or companies are obliged to publish accounts. For this reason, we believe UK audit firms should already be transparent.

**22. What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?**

The ICAEW and the Financial Reporting Council published “The Audit Firm Governance Code” in 2010. This provides a formal benchmark of good governance practice against which the eight audit firms which together audit about 95% of the companies listed on the main market of the London Stock Exchange can report for the benefit of shareholders in such companies.

**23. Should alternative structures be explored to allow audit firms to raise capital from external sources?**

This could be useful in two circumstances, to allow firms to recapitalise in the event of audit firm collapse, and to allow firms to grow their practices to enable them to enter the audit market for the largest companies. The Government would support an exploration of the likely demand for, and consequences of alternative structures.

**24. Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?**

The Government supports the Commission’s proposals in the Green Paper to allow group auditors to have access to the reports and other documentation of all auditors reviewing sub-entities of the group.

## **SUPERVISION**

**25. Which measures should be envisaged to improve further the integration and co-operation on audit firm supervision at EU level?**

The UK supports the aim of enhancing co-operation between national regulators, perhaps by the formation of a college of regulators, rather than additional layers of supervision which could risk adding to the cost of regulation more than they add to the benefit of stakeholders. We would like to play a constructive part in further discussions in this area, but we do not currently see the need for a new, EU level, inspectorate.

**26. How could increased consultation and communication between auditor and the regulator be achieved?**

The FRC and FSA have published a Discussion Paper<sup>13</sup> envisaging a closer working relationship between auditors and financial service regulators in the UK in order to contribute to prudential supervision. See responses to Q1,2,3 and 17. The UK Financial Services and Markets Act 2000 (s. 343) provides an information gateway for auditors of regulated bodies to provide information to the regulator, and associated regulations<sup>14</sup> sets out the circumstances where the auditor of a regulated body is to communicate such information to the regulator.

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<sup>13</sup> FRC FSA Discussion Paper: Enhancing the auditor’s contribution to prudential regulation (June 2010) <http://www.frc.org.uk/publications>

<sup>14</sup> Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 (SI2001/2587)

## CONCENTRATION AND MARKET STRUCTURE

### **27. Could the current configuration of the audit market present a systemic risk?**

While the market for the supply of audit for public interest entities in the UK is highly concentrated, it is doubtful whether in fact the failure of a Big 4 firm would cause systemic risk to the economy. This is partly because, as set out in our answer to Question 2, audit is only one element in the regime of corporate governance. The other elements of corporate governance act as a support or substitute for audit. In the Andersen/Enron case, there was neither a systemic effect upon US markets, nor a general decline in US share prices, nor even a specific decline in the share prices of Andersen clients<sup>15</sup>. This suggests that it is unlikely that there would be a systemic effect arising from the collapse of a Big 4 auditor.

### **28. Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?**

Joint audits are already legal in the UK, and the Government would not want to inhibit companies from voluntarily opting for a joint audit. The experience in the UK is that joint audits used to be more common, but companies moved away from them because they found the single auditor model more efficient and effective. The Government is therefore not convinced of the need for mandation in this area.

### **29. From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?**

Mandatory rotation of audit firms would ensure that no audit firm retained an audit beyond a fixed period. We have examined the evidence for whether mandatory rotation increases competition in the audit market. When mandatory rotation was introduced in Italy, it did not reduce concentration in the audit market. Independent academics found that mandatory rotation increased the probability of collusion among audit firms in order to coordinate acquisition of clients<sup>16</sup>.

Mandatory *tendering* would add auditor selection costs to companies and tender costs to the firms participating in the tender process. Mandatory *rotation* would add additional costs to these tendering costs. We have

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<sup>15</sup>K.Nelson, R.Price, B.Rountree *The market reaction to Arthur Andersen's shredding of documents: loss of reputation or confounding effects?* Jones Graduate School of Management, Rice University (March 21008)

<sup>16</sup>The Audit firm rotation rule: a review of the literature Cameran, Vincenzo, Merlotti Bocconi School of Management 30 September 2005

estimated<sup>17</sup> that if implemented in the UK, mandatory rotation once every 5 years would add at least £55m per annum of costs to UK companies, without any guarantee that the audit would be awarded outside the Big 4.

However action might be taken to encourage rather than enforce rotation. In the event of any tender, companies might be encouraged to invite a non-Big 4 firm to tender as a norm. Such a system of voluntary tenders would be aimed at promoting fluidity in the audit market.

A different approach might be via EU or Member State competition authorities. However, this would need very careful analysis as there is a considerable risk of unintended consequences.

### **30. How should the “Big 4 bias” be addressed?**

The approaches discussed in the answer to Q8 (on audit committees) and Q29 may give other firms the opportunity to tender for audits. The ability for non-Big 4 firms to recapitalise themselves, as discussed in the answer to Q23 may also allow firms to change perceptions.

The issue of “Big 4 only” clauses is a matter for the competition authorities..

### **31. Do you agree that contingency plans, including living wills, could be key in addressing systemic risks and the risks of firm failure?**

It is unlikely that the failure of a single audit firm would cause a systemic risk (see Q27). We do not believe that any single audit firm is "too big to fail" and any contingency plan should be careful not to cause moral hazard. It is important that Member States, regulators and firms have contingency plans against the risk of market disruption. Plans would need to be co-ordinated cross border.

The simplest and most immediate response may include allowing more time for filing audited accounts of a failed firm or to allow split filing of accounts, that is, allow the unaudited accounts to be filed with the registry by statutory deadline and then allow an additional period of time, say 2 months, to file the audit. These options would require the introduction of a *force majeure* clause to be introduced in the Transparency Directive, which requires all companies on the main market to publish their audited accounts within 4 months of their

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17 These costs have been infrequently examined by research, but they were reported on by The United States General Accounting Office in 2003. United States General Accounting Office, *Public Accounting Firms: required study on the potential effects of mandatory audit firm rotation* Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services (November 2003). They estimated that mandatory rotation would produce costs as follows: companies would incur auditor selection costs in the year of rotation of 17% of the first year audit fees; audit fees would increase in the first year of audit by 20%; auditors marketing expenditure would increase by 5% - 10%, which costs would be added to audit fees. Assuming UK listed audits est. £750m per annum (source: FAME database), if a fifth of audits rotated every year (audit fees £150m), additional audit selection costs would be £25m, and additional first year audit fees would be £30m. This gives a total cost of £55m. It is not possible to estimate additional marketing costs of all audit firms.

year end and an amendment (or *force majeure* clause) to the 4th Directive that requires that the accounts are accompanied by an audit when filed at the Registry. These changes would be useful preparatory moves at EU and Member State levels.

We would encourage member states (and the Commission) to produce contingency plans to allow a considered response should an audit firm fail. Any plan must give regard to a range of legal and operational constraints, for example, human rights, employment law and prohibitions on restraint of trade.

**32. Do you consider the reversal of past consolidation of audit firms a valid option for consideration in order to improve the service on offer as well as the choice of service providers?**

Any actual reversal of consolidation in the audit firms has to date been divestment only of consultancy arms at the firms' own instigation. Any enforced break up of firms would have to be on a global scale, and this could introduce a very high risk of unintended consequences.

## **CREATION OF A EUROPEAN MARKET**

**33. What in your view is the best manner to enhance cross border mobility of audit professionals?**

We are unaware of any significant problems requiring action at EU level. It is vital that any changes to regulation at EU or Member State levels are evidenced by an assessment of the economic impacts which demonstrates that the benefits exceed the costs.

**34. Do you agree with “maximum harmonisation” of the market for audit services combined with a single European passport for auditors? Do you believe this should also apply for smaller firms?**

Whilst in favour of harmonisation of audit services, standards would need to be set so as to preserve audit quality.

We welcome the creation of a single European passport for auditors and audit firms. Smaller firms who wish to operate only within one Member State, offering services only to unlisted small and medium sized companies should not be required to obtain the passport, but they should be able to if they wish.

If this proposal is intended to replace the aptitude test operating at member state level under Article 14 of the Statutory Audit Directive, we would want to be assured that the registration requirements strike the right balance between requiring the necessary capacity for registered auditors to provide services in various member state legal contexts, and not imposing an excessive barrier to entry as described above.

An alternative approach this might be for pan EU-registration to be required for audit firms, while the registration of individual auditors and the recognition

of their qualifications to sign audit reports (including the Article 14 aptitude test) could continue to operate at member state level.

## **SIMPLIFICATION: SMALL AND MEDIUM SIZED ENTERPRISES AND PRACTITIONERS**

### **35. Would you favour a lower level of service than an audit, a so called “limited audit” or “statutory review” for the financial statements of SME’s instead of a statutory audit? Should such a service be conditional depending on whether a suitably qualified (internal or external) accountant prepared the accounts?**

There are no systemic risks to reducing mandatory audit requirements for unlisted companies. The UK has successfully introduced audit exemptions permitted by the Directives for small companies without any ill effects, and there are significant jurisdictions outside the EU where audits for unlisted medium and large companies are not mandatory. The removal of mandatory audit would have the added advantage of restoring the signalling effect of audits of medium sized companies<sup>18</sup> to lenders and might even lead to reductions in the cost of capital.

We are therefore very much in favour of making audits for some, preferably all, medium sized, unlisted companies voluntary. At present a company in the UK that meets two out of the three EU criteria is classified as medium sized<sup>19</sup>. Preliminary analysis of the UK population of companies shows that 32,385 of medium sized companies are unquoted<sup>20</sup>, and could be relieved from the burden of a mandatory audit.

The table below analyses the population of UK unlisted medium sized companies into a series of stepped size banks. This indicates the effect that gradually raising the threshold for the mandation of medium audits could have. Such an exemption could be introduced by Member States in stages, starting with the “smaller end” of medium sized. In order to demonstrate the number of medium sized, unlisted companies that a staged introduction would affect, the following table shows the number that would still be classified as medium by the employment and balance sheet criteria at different levels of maximum turnover criterion.

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<sup>18</sup> See attached Appendix “Government Memorandum of Evidence”.

<sup>19</sup> turnover more than £6.5m and less or equal to £25.9m,  
total assets of more than £3.26m and less or equal to £12.9m  
number of employees more than 50 and less or equal to 250

<sup>20</sup> Source: FAME. Figure includes Limited Liability Partnerships

<b>Different levels of maximum turnover criterion</b>	<b>Number of medium unlisted UK companies</b>
Less or equal to £25.9m	32,385
Less or equal to £20m	27,030
Less or equal to £15m	22,047
Less or equal to £10m	13,594
Less or equal to £5m	2,363
Less or equal to £2.5m	394

**36. Should there be a “safe harbour” regarding any potential future prohibition of non-audit services when servicing SME clients?**

Because there is no systemic risk involved in the audits of SMEs, we support auditors of such companies being allowed to provide a wider range of non-audit services than may be provided to listed companies, provided the degree of the auditor’s objectivity is clear. UK Ethical Standards address this via the Auditing Practices Board’s “Provisions for Smaller Entities”.

However, we do not support a general prohibition on non audit-services for large companies(see Q19).

**37. Should a “limited audit” or “statutory review” be accompanied by less burdensome internal control rules and oversight by supervisors? Could you suggest examples of how this could be done in practice?**

The UK has experimented in the past with forms of limited audit in the current regulatory framework but these have not proved effective. However, an extension of the audit exemption to medium sized, unlisted companies (see Q35) could open the way for further innovation and simplification in this sector.

**INTERNATIONAL CO-OPERATION**

**38. What measures could in your view enhance the quality of the oversight of global audit players through international co-operation?**

We support greater co-operation between national regulators on matters such as audit inspections and the oversight of the global network bodies, as well as the formation of a college of regulators (see Q25). International cooperation would be vital in the event of a large firm finding itself in difficulty (see Q31).

APPENDIX  
EVIDENCE SUBMITTED TO THE HOUSE OF LORDS BY BIS



INQUIRY BY THE HOUSE OF LORDS ECONOMIC AFFAIRS COMMITTEE  
ON “AUDITORS: MARKET CONCENTRATION AND THEIR ROLE”

GOVERNMENT MEMORANDUM OF EVIDENCE  
10 September 2010

**Introduction**

1. The Government welcomes this inquiry, which is one of a number of initiatives looking at the role of audit in the aftermath of the financial crisis. The Government has not reached firm conclusions on the need for changes to the present role of audit, since it would be wrong to do so until the conclusions of the present debates are clear. Any response to the financial crisis needs to be based on sound evidence, not knee jerk reactions or partial analysis. The Government is willing to consider alternatives, with the aim of ensuring high quality, but cost effective audit assurance for UK companies, in order to ensure the maximum economic benefits to companies and the UK economy.
2. Apart from the work of the Select Committee, there are several other important streams of work presently ongoing, amongst which are:
  - a. the Financial Services Authority (FSA) and the Financial Reporting Council (FRC) have issued a Discussion Paper on “Enhancing the auditor’s contribution to prudential regulation”;
  - b. the European Commission is scheduled to publish a wide ranging Green Paper on audit in the Autumn;
  - c. the FRC has announced that it expects to publish, also in the Autumn, a discussion document to examine the lessons learned from the credit crisis and other market developments as they impact corporate reporting, accounting and auditing of non-financial services companies.
3. The Government asked its officials to review the evidence base on the role and value of audit in order to assist in determining the direction of future policy. The discussion of the academic and other papers referred to in this memorandum is a result of this exercise. The results of the review of the evidence base have also been sent to the European Commission and the FRC.

**The regulation of audit and the Government’s role**

4. The present structure for statutory audit in the UK is based on the Companies Act 2006. Shareholders of companies (unless exempt – such as most small companies) are required to appoint external auditors for each financial year. The auditor is required to report to shareholders on whether the accounts have been properly prepared and constitute a true and fair view of the state of the company's affairs.
5. The auditor is required to follow the technical and ethical standards as set by the Auditing Practices Board, and an audit firm wishing to be appointed as a statutory auditor in the UK must be registered with, and supervised by, their Recognised Supervisory Body<sup>i</sup>. Auditors are subject to inspection by the Recognised Supervisory Body (RSB) to which they belong, and these RSBs are in turn overseen by the Professional Oversight Board (POB), part of the FRC. Through its own Audit Inspection Unit, the POB reviews the quality of the audits of listed and other major public interest entities. Smaller audits are subject to review by the monitoring units of the RSBs. A further part of the FRC, the Accounting and Actuarial Discipline Board provides for independent investigation of important cases of poor auditing.
6. The Department for Business, Innovation and Skills has the following roles in relation to audit:
  - a. It is responsible for the Companies Act 2006 and associated regulations.
  - b. It takes the UK seat on the Audit Regulatory Committee, which assists the European Commission in its adoption of measures under the Statutory Audit Directive using the comitology procedure.
  - c. It is responsible for the regulatory framework of UK law on audit, and for ensuring that it remains consistent with EU law, by implementing into UK law the 2006 EU Statutory Audit Directive and associated Commission Decisions.
  - d. It keeps abreast of audit issues as an observer on the UK's Auditing Practices Board and through contacts with stakeholders.
  - e. It sponsors the Financial Reporting Council.
7. We have attempted to estimate the costs of audit in the UK: information provided to the Professional Oversight Board by 31 of the larger UK audit firms, shows that together they earned in excess of £2billion in 2009 in audit fees<sup>ii</sup>.

### **The present challenge**

8. The aftermath of the financial crisis has raised questions about the role of audit, in particular why banks failed shortly after having clean audit reports, and what the role of audit is, if it is unable to warn of such incidents. These questions were articulated very clearly by the 2009 report of the House of Commons Treasury Select Committee.

Alongside the questions raised by the economic crisis, there are other current pressures for change: the investor community has been expressing concern about audit reports, including that they should contain much more useful qualitative information about the company, rather than just the “pass or fail” opinion on the numbers in the accounts that is currently provided. Alongside that, there is the longstanding concern, discussed later in this evidence, about the concentration of supply of major audits in the hands of a very small number of audit firms.

9. The present crisis is not, of course, the first to result in challenges to the audit structure. It is notable that the reaction to this and previous crises or scandals has been to tighten the regulation of accounting and audit. The present system came into being largely as a result of the Enron and other corporate scandals in the last decade: amongst other measures, the ethical standards of the Auditing Practices Board have been revised; the Audit Inspection Unit was formed for monitoring the audits of all listed and other major public companies; and law now contained in the Companies Act 2006 increased the rights and powers of auditors in relation to information from employees, officers, directors and subsidiaries. Nevertheless, these steps have not prevented some parties from criticising audit and the auditors for failing to stop the most recent crisis from occurring. Others feel that the crisis cannot be attributed to a failure in audit and auditors.
10. As a result, the Government is inclined to be cautious about adding to the role of audit or its regulation in relation to published accounts enhancements, which have the potential to increase costs to the economy, unless it is clear there are significant benefits, and these have been demonstrated by a robust assessment of the economic impacts, in line with the Government’s commitment to better regulation. The outcome of this , and other current debates will inform Government thinking.

### **The role of audit**

11. Ideally, the current debate on the role of audit would be based on a clear understanding of exactly what value audit adds to the economy. Unfortunately, the academic and other evidence on this is not conclusive.
12. The theoretical rationale<sup>iii</sup> for audit is that it is demanded under two conditions:
  - a. accountability, whereby an agent gives an account of his actions to a principal;
  - b. complexity, where principals are distant from the actions of an agent and unable to verify them.

This leads to two consequences:

- a. moral hazard, when agents may act against the principals' interests;
- b. information asymmetries, when agents know more than principals.

Thus audit is a risk reduction practice which benefits the principal because it inhibits the value reducing actions by agents. The categories of principal and agent can be filled out in a variety of ways. Principals can comprise, for example shareholders, creditors and tax authorities.

13. In voluntary audit environments<sup>iv</sup>:

- where a company has an audit voluntarily, it does benefit from a reduction in its cost of capital because of the signalling effect of the audit<sup>v</sup>,
- the bigger the company the more likely it is to have a voluntary audit<sup>vi</sup>.

14. The theoretical justification for mandating audit is that it increases confidence in, and the strength of, the financial system, but it is not clear, for instance, what value is added by a mandatory (rather than voluntary) audit regime: for example, whether mandating audit works to decrease the cost of capital across the economy<sup>vii</sup>.

15. In mandatory audit environments, the signalling effect of voluntary audit is lost, because all comparable firms have to have an audit, but voluntarily opting for higher quality audit<sup>viii</sup> enables companies to regain some of the effect. This research also demonstrates that bigger companies gain disproportionately more from higher quality audits than smaller companies do. Bigger audit firms are perceived to offer higher quality audits<sup>ix</sup> partly because of their increased expenditure on training, systems and branding, partly because they have more to lose in reputation<sup>x</sup> and partly because they have more to lose via litigation<sup>xi</sup> (auditor liability). It is difficult to split these effects<sup>xii</sup>. There is some evidence that audit firms that specialise in industry sectors deliver audits that are acknowledged to be higher quality, but the effect is reduced in regulated industries (e.g. banking) because regulation acts as another substitute<sup>xiii</sup>. Financial directors and investors do however find audit valuable in checking company compliance with accounting standards and other regulatory requirements<sup>xiv</sup>, while they do not find value in the very limited (and often boiler-plate) qualitative assessment currently provided<sup>xv</sup>.

16. There are other modes of assurance available for regulators, companies and investors as an additional support or substitute for audit and vice versa. These include accounting standards, dispersed ownership, risk management committees, audit committees<sup>xvi</sup>, internal auditors, credit ratings, insurance markets, investment analysts, or additional disclosures above those mandated by accounting standards and the law, and regulatory and supervisory bodies. Hence, rather than having a unique role to play in corporate reporting, the importance of

audit is as one element in a multi-faceted regime of corporate governance and regulation<sup>xvii</sup>.

17. Mautz and Sharaf, in their seminal work on auditing (1961)<sup>xviii</sup>, suggest that audit works best in normal environments – that is, in non-collapsing systems and non-fraudulent firms – where auditors can expect that normal audit procedures will uncover normal errors and normal managerial misstatements. This suggests that audit cannot provide a defence against systemic risk in an economy<sup>xix</sup>. Audit also provides only a limited defence against material fraud in a company, especially where there is significant collusion by senior management. These issues give rise to the much quoted expectation gap, which arises where people expect to get more assurance out of an audit than is in reality provided, or can be provided. - there is an expectation gap in as much as the audit is often assumed to provide a greater degree of assurance than it can actually provide..

#### **Way forward – debate on mandating audit?**

18. Given this evidence, it seems to the Government that there is value in a debate about the extent to which audit should be mandatory, and what the nature of any mandated audit should be. The Government's view is that audit has an important but not unique role to play in ensuring vibrant capital markets. It is less clear that a modern audit, designed largely for listed companies with diverse shareholders, should necessarily be imposed on, for instance, a medium sized owner-managed company. This is a debate which will need to take place at EU level; the current accounting directives do not allow the audit requirement to be lifted, other than from small companies or subsidiaries. At the same time, given the importance of key financial institutions to the economy, the Government recognises the need for auditors to contribute to prudential supervision as described in the FSA/FRC Discussion Paper.

#### **Auditor Independence**

19. Professor Ray Ball suggested that both the fact that auditors are remunerated by companies and the total level of that remuneration inevitably affect auditor independence and judgement<sup>xx</sup>. This has the potential to make it hard for auditors, who are in reality selected by management<sup>xxi</sup>, and who are commercial organisations, to stand up to management, particularly when financial results are poor<sup>xxii</sup>. Lennox (2000) shows that companies are able to engage in opinion shopping<sup>xxiii</sup> in their choice of auditor. However, opinion shopping in the UK is likely to be infrequent, given the very low switching rates for auditors described later in this paper. Geiger and Raghundan (2002) find some supporting evidence that auditors are more likely to issue a clean audit report prior to a bankruptcy filing in the early years of the auditor-client relationship<sup>xxiv</sup>. However, there are a number of reasons that there may be problems in the first year of an audit relationship, as

the auditor builds familiarity with the client's business, and audit and its regulation have changed significantly since Enron<sup>xxv</sup>.

20. The Government's view is that while there is no evidence of systematic problems of auditor independence, the body best placed to bolster auditor independence is a strong audit committee.

### **Way forward – what should be in the report?**

21. The challenge to auditors that they should have seen the bank collapse coming is linked to the question about what should be said in the audit report, which has been raised by investors and other users. Elements of the developing investor view are that the standard audit report is not very useful at present in that it is of standardised form, and could be reformed to include useful company-specific information and the auditor's view as to the degree of aggression in the company's accounting choices. There could also be more disclosure about the risk position of the company, and the key judgements taken during the course of the audit. Such an approach, it could be argued, might have provided some forewarning of the collapse of the banks, but it is hard to see that audit alone could provide a defence against systemic risk of that kind. However, the Government is committed to the objective of improving bank corporate governance and will continue to work closely with the EU and internationally to increase transparency and accountability in a consistent and proportionate manner. The joint Discussion Paper by the FSA and FRC already referred to explores wider ideas about the contribution of audit to prudential regulation.
22. The audit profession concedes that there may be some room for improvement in making audit reports more informative, but it has concerns that by providing more information or assurance, it will be exposed to greater liability. This could tend to push up fees, or increase pressure for more liability protection for auditors, or both. Ian Powell, the Chairman of PWC in the UK is quoted as saying "On a bilateral basis, you will not see an auditor start making a more informative audit report while the rules are as they are and there's unlimited liability"<sup>xxvi</sup>. There would need to be clear evidence that the information benefit exceeded the cost either in fees or liability capping before Government would act.
23. It is not clear that the company specific information sought by users is best provided by an auditor. There is an argument that such issues and information about the company are more properly disclosed by the audit committee and management, with the auditors then possibly providing some assurance over the accuracy of the information. Whether information were to be disclosed by the company or by the auditor, it would be a challenge to ensure that genuinely useful company specific information is provided, and not just boiler plate. It is by no means clear that a mandatory requirement is the best route to

securing disclosure of the information. Some form of voluntary route could be considered, perhaps by an amendment to the UK Corporate Governance Code.

24. Research on a sample of listed companies published in 2009 by the Financial Reporting Council shows that for many listed companies there is much room for improvement in their narrative reporting as required by the Companies Act. In the reporting of the principal risks facing their business, 66% of companies were technically compliant with the law, but fell short of the spirit of the requirements. In providing a description of their business, 58% of companies were either not compliant with the law, or were technically compliant but fell short of the spirit.<sup>xxvii</sup>
25. It is therefore not obvious exactly how to achieve more informative disclosure of the affairs of companies, either by management or by the auditors. There are clearly costs associated with the various routes, and it may be hard to achieve the benefits desired. It is for these reasons that the Government has not come to a firm view on the way forward, and wishes to see the outcome of this inquiry by the House of Lords and other debates.

### **Audit market**

26. The market for the supply of audit for public interest companies in the UK is very concentrated. Just four firms undertake the audits of 99% of FTSE100 companies and 95% of FTSE 350 companies. Complex sectors such as finance are already reduced to two or three audit firms that have the necessary expertise to undertake these audits while auditor independence rules can further reduce this choice.
27. In the late 1980s there were eight major accounting firms that provided audit services. Since 2003, there have only been four. This is a result of a series of mergers including Price Waterhouse and Coopers & Lybrand, which was approved by the EU in 1998 and the collapse of Arthur Andersen in 2002, which resulted in the UK firm merging with Deloitte. The Deloitte merger was approved by the EU who raised competition concerns but concluded there was no better alternative as the international Andersen network had effectively collapsed.
28. The share of the audit market held by the Big 4 differs across G8 countries. In 2007, Canada, Italy, UK and US had the greatest concentration of the Big 4, accounting for a market share of 95% or higher, followed by Russia at 90%, Japan at 84% and France at 61%.
29. The high concentration levels in the UK audit market are limited to the audit of FTSE 350 companies. Smaller companies have access to a much wider selection of firms, for example there are 119 medium sized

audit firms with between 11 and 50 Principals<sup>xxviii</sup>.

30. The Government has been concerned about competition for FTSE 350 audits for some time. BIS and the FRC jointly commissioned an independent analysis<sup>xxix</sup> of competition in the audit market. This paper was published in April 2006 and the main findings were:
- a. The FTSE350 market for audit services is highly concentrated.
  - b. Switching rates are low at around 4% on average for all listed companies, and 2% on average for FTSE100 companies.
  - c. A limited number of UK listed companies, primarily in the financial services sector of the FTSE100, have no effective choice of auditor in the short run. This elimination of choice is driven by high market concentration, auditor independence rules, supply-side constraints, and the need for sector expertise.
  - d. Higher concentration has led to higher audit fees (although this finding of the report has been disputed). While there is a degree of price sensitivity among companies, and some bargaining on fees takes place during the annual audit firm reappointment process, in general the focus of audit committee chairs is more on quality (and reputation) than on price. Separately from the impact of concentration, audit fees seem to have risen in recent years as a result of cost increases, caused by factors such as change in regulation.
  - e. A range of barriers to entry to new competitors helps to sustain this concentration, in particular
    - i. Acquiring a credible reputation/perception of reputation;
    - ii. Establishing an extensive, integrated network; and
    - iii. Resource and technical expertise in audit.
31. In response to the competition issue, the FRC established the Market Participants Group (MPG), which comprised representatives from companies, investors and audit firms. They were tasked with advising the FRC on possible action to mitigate the risks arising from the concentration. Their advice was limited to market-led solutions with responsibility for implementation of their recommendations falling to the FRC. Most of the recommendations<sup>xxx</sup> have now been implemented and the FRC recently published their fifth progress report<sup>xxxi</sup>. They have found that the market-led approach has not had a significant impact on market concentration and the FRC are currently undertaking a review with the aim of developing further proposals. This review, alongside the Commission Green Paper, will feed into HMG's future policy on competition in the audit market.
32. The Government will be working closely with the FRC on its review. Without in any way wishing to prejudice the outcome of that review, the Government's initial view is that, with the current (four-player) state of the audit market, it may be difficult to identify measures that will be

effective in increasing choice for the largest audits without also imposing major costs. Those costs might be hard to justify.

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