The Hundred Group
of Finance Directors

Investor Relations and Markets Committee

Commissioner Cathy Ashton
High Representative of the Union for Foreign Affairs and Security Policy
European Commission
Rue de la Loi 200
B-1049 Brussels

27 September 2011

Dear Commissioner Ashton

Proposals to reform the market for External Audit Services within the European Union

We are writing to express our concerns over the European Commission's proposed reforms to the market for external audit services in advance of legislation being proposed. We are aware that there has been considerable speculation over recent weeks as to the likely thrust of the forthcoming legislation and the views expressed in this letter are set out without the benefit of having seen the proposals in their final form.

Who we are

The Hundred Group is a non-political, not-for-profit organisation which represents the finance directors of the UK's largest companies, with membership drawn mainly, but not entirely, from the constituents of the FTSE100 Index. Our aim is to contribute positively to the development of UK and International policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the view of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

Our views

As Directors of large public companies, we recognise the value to our shareholders of the financial statement audit. The independent auditor's report is important in ensuring the smooth and efficient operation of capital markets and consequently any action taken to reform this market should be aimed at enhancing, and not diminishing, audit quality.

We are deeply concerned to hear that the Commission is considering legislating for mandatory joint audits, mandatory auditor rotation, the creation of specialist audit firms and the widespread prohibition of non audit services. Such radical and untested proposals are likely to have very significant and profound implications for the way audits are conducted, none of which are likely to be positive to investors or other stakeholders.

In our view, these proposals show a fundamental misunderstanding of both the way that external audits are conducted and the current structure of the audit market. They will have the effect, both directly and indirectly, of reducing audit quality, increasing cost and diminishing the value of the audit opinion to investors, without any compensating tangible benefits.

Joint audits

Our experience of joint audits, predominantly arising through merger and acquisition activities, is that they encourage loss of clear accountability between audit firms; significantly increased management time; expend energy in competition without improved service; duplicate regulatory /compliance requirements and increase costs. They can also have the unintended consequence of reducing the quality of the audit, as each joint auditor seeks to adjust their level of professional scepticism to be consistent with the other: Auditors today do not have to compromise on their opinions. In the UK there is no restriction over the ability to perform a joint audit – but there is no market demand and these are consequently very rarely seen in practice. This proposal appears to seek to promote smaller firms into the audit market for global companies, in which they are patently ill equipped to operate.

Auditor appointment

We strongly believe that the right to appoint, evaluate and determine the tenure of auditors should be retained by shareholders as the strong and necessary arm of corporate governance. In the UK, this is done annually at the Annual General Meeting, such that all auditors only have a tenure of one year. For multinational Companies with subsidiaries in many countries, mandatory rotation every 5 years, particularly combined with a cooling off period, has the effect of reducing competition and choice to an unacceptably low level, especially given current legitimate constraints on appointing, as auditor, a company which is already offering the group consultancy services. Rotation also risks a reduction in audit quality in the initial and final years of the appointment. We do not recognise, and have seen absolutely no recent evidence of (so called) 'institutional familiarity' and in our view, the regular rotation of audit partners is sufficient to maintain an independent and robust audit. The inevitable reduction in audit quality could only be alleviated by increased audit fees during the transition years – a cost which very few investors have expressed a desire to incur.

Non Audit Services

We agree that it is appropriate to prohibit auditors from undertaking certain specific non audit services (e.g. consultancy) where independence could be impaired. However with appropriate safeguards in place, the quality of both the external audit and other specific non audit services can be enhanced if undertaken by the auditor without any impact on independence, and at lower cost. We also oppose the creation of specialist audit firms as these will undermine the ability of firms to recruit the appropriate quality of audit staff, with consequent highly negative implications on long term audit quality.

In the appendix to this letter, I have set out a summary of our views on the external audit market and we urge that the Commission takes these into account when finalising its proposals.

Please feel free to contact me if you wish to discuss the views contained within this letter.

Yours sincerely

Robin Freestone
Chairman
Investor Relations and Markets Committee

Cc: Ed Davey MP, Department for Business, Innovation and Skills
Mark Hoban MP, HM Treasury

Appendix 1: Position Statement of the Hundred Group of Finance Directors on the market for external audit services

1. Context

- We recognise the value to our shareholders of the financial statement audit. The independent auditors report is important in ensuring the smooth and efficient operation of the capital markets.

- National action in isolation to reform the audit market risks undermining the relative attractiveness of the UK as a place to do business.

- We are cautious of developments which may, either directly or indirectly, affect the relationship between the auditors and the Audit Committee or which lead to a proliferation of prescriptive disclosures in an attempt at transparency.

2. Form and content of the audit report

- We support moves to simplify the audit report and make the audit opinion more prominent.

- We understand that an expectation gap may exist and see no reason why additional explanatory material could not be disclosed, however extending disclosures goes against moves to make the opinion more accessible.

- The auditors are not responsible for, nor should be requested to present information on, the strategy, risks and management of the company. This is at best repetitive, and at worst fundamentally undermines the relationship between Directors and investors.

3. Role of the Audit Committee

- Our Audit Committees consistently provide a frank and open environment which challenges both management and auditors.

- Requiring the Audit Committee to publish its own report invites the inclusion in the financial statements of boiler plate disclosures which do not improve transparency. Such reports should focus on the nature, rather than the substance, of Audit Committee deliberations.

- The Audit Committee relies to a certain extent on the auditors work. To additionally require the auditors to opine on an Audit Committee report creates circular reporting which is at best unnecessary and at worst undermines the relationship between the auditor and the Audit Committee.

4. Appointment and re appointment of auditors

- The right to appoint, evaluate and determine the tenure of auditors should be retained by shareholders as the strong and necessary arm of corporate governance.

- We oppose mandatory audit firm rotation, however we support the regular rotation of key audit partners to decrease the threat of familiarity.

- We oppose a regime of mandatory tendering, and recommend that the decision to tender is taken by the Audit Committee.

- We oppose appointment by a third party as this risks diluting the accountability for ensuring a high quality audit.

- We estimate that the members costs of tendering and rotation are between 5 and 30% of the audit fee depending on the extent of the tender process.

5. Joint Audits

- We oppose the concept of joint or shared audits.

- Joint audits encourage loss of ownership between firms, expend energy in competition without improving service and increase costs. They risk compromising auditor independence if firms compete to satisfy management expectations.

- In our experience, there are cost implications where the auditor at the centre has to rely on the work of another audit firm elsewhere in the Group.

6. Audit market concentration

- We believe that the services rendered by the 'Big 4' are of a high quality and that there exists sufficient competition in the market place to drive continuous improvement and breadth of choice to our shareholders.

- We support measures that allow the development of other providers, particularly those which enhance global presence and technical depth.

- The creation of specialist audit firms is more likely to reduce audit quality as it will undermine the ability of firms to recruit the appropriate quality of audit staff.

- The systemic risk of the current market structure is overstated due to the national nature of the big audit firm practices. The focus should be on developing living wills.

7. Non audit services

- The independence of auditors is paramount, and must be retained in order to uphold the quality and credibility of their offering.

- We are not convinced that independence is compromised by the provision of non audit services if the appropriate safeguards are in place.