pwc

7 September 2012

Comments on Competition Commission Working Paper: "Development of the statutory financial audit"

1 We set out in the table below, PricewaterhouseCoopers LLP's (PwC) detailed response to the Development of the Statutory Financial Audit Working Paper (the Working Paper or the paper). However, before addressing the detail of the paper, we make some overarching comments.

2 On the basis that the Working Paper aims to provide some background and relevant context to statutory financial audit in the UK, it is important that it provides a complete, accurate and fair summary of the development of audit over time. With this in mind, we have two principal concerns in relation to the Working Paper:

(a) First, the Working Paper fails to provide a complete picture of the development of statutory financial audit. There are numerous omissions in the historical section of the paper and it appears that random stages of development have been selected whilst several other fundamental events in the development of the statutory financial audit have been omitted entirely; and

(b) Secondly, in a number of places, the Working Paper contains comments and subjective conclusions, which are misleading and/or lack balance and perspective and which do not appear to be supported by evidence.

3 We summarise these two concerns below.

Incomplete picture of the development of audit

4 In our response to paragraph 4 of the Working Paper in the table below we have provided examples of significant landmark dates and important developments in the statutory financial audi which have been omitted from the Working Paper. Whilst all of the events listed are important, the following are of critical importance:

(a) the reforms to corporate governance, and in particular the introduction of audit committees. In order to properly analyse the revised second theory of harm, it is essential to have an appreciation and understanding of the role of the audit committee and how this has evolved as part of the corporate governance regime; and

(b) the development of UK auditing standards, UK ethical standards and UK audit regulations. An understanding of the development of the regulatory framework and of these standards is essential to an understanding of the audit market in the UK.

5 If the Competition Commission disagrees that any of the events suggested should be included in a historical account of the development of statutory financial audit, it would be helpful for us to understand on what basis the Competition Commission is selecting particular events and omitting others.

Prejudicial conclusions and selective presentation of evidence

6 We are concerned that the Working Paper contains a number of comments and selectively presents evidence such that it is misleading and/or lacks balance and perspective. This occurs, in particular, in the following instances:

(a) Paragraph 2 of the Working Paper refers to the establishment and "*subsequent growth in power*" of audit firms. The reference to the growth "*in power*" is a subjective conclusion, not backed up by any evidence or explanation. We disagree with the suggestion that the large audit firms have market power[1].

(b) Paragraph 59 of the Working Paper states that the banking crisis of 2008 "*highlighted that considerable shortcomings remained in the audit system*". No explanation is provided for reaching this conclusion which is not consistent with the finding of the House of Commons Treasury Committee Report into the collapse of Northern Rock (see footnote 44 to our Response to Certain Third Party Submissions). We have made detailed submissions to you on this point in our previous submissions.[2] We do not understand why this conclusion has been included in a Working Paper dealing with the history of the development of audit without any explanation of how or why it has been reached.

(c) The Working Paper's presentation of the introduction of the Limited Liability Partnerships Act 2000 (LLPA) as "controversial" in paragraph 42 is subjective and misleading. In fact the LLPA bill had broad cross-party support.[3] The extensive quotation from Austin Mitchell MP is the only evidence relied on to support the statement that the LLPA bill was "controversial" and this gives an entirely wrong impression of the extent of disagreement surrounding the bill. Mr Mitchell, at the time a Government backbench MP, is well known for his negative views of the auditing

---

1 PwC Submission and Response to Issues Statement, 12 January 2012 (paragraphs 1.5-1.10,1.11(a), 7.3-7.9)
2 PwC Submission and Response to Issues Statement, 12 January 2012 (paragraphs 1.22-1.25, 2.56-2.57) and PwC Response to certain Third Party Submissions (paragraphs 3.3-3.5)
3 This is evidenced in Hansard, for example, see 9 December 1999 vol 607 and 23 May 2000 vol 350

profession but his opinion was in the minority. In these circumstances to include the quotation of Mr Mitchell is inappropriate. Please see further our comments in the table below in response to paragraph 42.

(d) By contrast, in paragraph 60 the European Commission proposals for reform of the audit process are not acknowledged to be controversial, despite the opposition to the proposed reforms that has been voiced by a range of stakeholders.

7 In addition to our overarching concern that the Working Paper does not currently provide a complete or balanced explanation of the development of the statutory financial audit, we set out below our detailed comments on the paper, including suggested amendments to the text where relevant. We reserve the right to respond further if information from this paper is used selectively in your provisional findings.

Paragraph	Text (including suggested changes)	Other comments
2	The development of the statutory financial audit is linked ~~both~~ to the development of company law, the recognition of the need for professional qualifications of auditors and ~~and to~~ the establishment (and subsequent growth ~~in power~~) of audit firms.	We have amended the text in paragraph 2 to make it clear that the emergence of the audit profession is also an important element of the development of the audit. As discussed above, the reference to the growth "in power" of audit firms should be deleted as this is a subjective conclusion, which is not supported by any evidence or explanation.
4	Landmark dates are: 1844 mandatory financial auditing provisions first appeared. 1856 the policy decision was taken to make auditing arrangements optional. 1895/96 the London and General Bank and Kingston Cotton Mill Company cases were decided. 1900 auditing provisions were once more made mandatory. 1948 ~~audit firms were given a monopoly of auditing~~auditors	We have amended the list of landmark dates provided in paragraph 4 so that it provides a complete list of the important events in the development of statutory financial audit. These dates relate to the significant events that we describe further below. For ease, the additional wording explains the relevance of those areas to the overall context of the paper. Please note that we have not attempted to draft specific new sections of the Working Paper to address these omissions, but recommend that they be considered for inclusion in any revised version of it or in the Competition Commission's provisional findings. There are a number of important developments in the statutory financial audit that have been omitted. In addition to describing

		required to obtain professional qualification (Companies Act 1948).	changes to legislation, we believe the Working Paper should address the history and development of:
	1970	Accounting Standards Steering Committee created.	• Corporate governance, in particular the introduction of audit committees, the requirement for membership to include non-execs and the establishment of required competencies of audit committee members, the roles and responsibilities of audit committees and how they reinforce both auditor independence and audit quality (see paragraphs 2.10 – 2.12 of our Submission and Response to Issues Statement dated 12 January 2012).
	1976	Auditing Practices Committee ("APC") established to formalise existing cooperation of the Consultative Committee of Accountancy Bodies ("CCAB") on audit practices.	
	1978	4th Council Directive on annual accounts.	• UK auditing standards. We attach a link to the ICAEW web page headed "Knowledge guide to UK Auditing Standards" which includes a timeline of developments from 1976: http://www.icaew.com/en/library/subject-gateways/auditing/knowledge-guide-to-uk-auditing-standards
	1980	first auditing standards and guidelines published.	
	1981	Companies Act gives effect to 4th Directive.	• UK ethical standards (including independence requirements).
	1983	7th Council Directive on consolidated accounts.	• UK audit regulations.
	1984	8th Council Directive on approval of persons responsible for statutory audits.	• The FRC and its operating bodies, including the FRC's role in regulatory oversight through the Conduct Division (and its prior operating bodies), and the evolution from peer review through member bodies to independent oversight. (There is an overlap here with section 5 ("Regulatory bodies and mechanisms") of the "Law and regulation" working paper dated 20 April 2012, which we provided our response to on 4 May 2012).
	1989	Companies Act recognizes accounting standards; auditors required to disclose fees paid for non-audit work; audit firms could become limited liability companies; introduction of audit regulatory regime (audit firms required to be a member of a recognised Supervisory Body to accept appointment as an auditor of a UK registered company).	• The profession within the UK, including the role of the Professional Institutes, Recognised Supervisory Bodies and Recognised Qualifying Bodies (see www.frc.org.uk).
	1990	Caparo Industries plc v Dickman case decided (duty of care of statutory auditors).	For a summary of the background to audits, and evolution of the regulatory regime, accounting and auditing standards we refer you to Section 2 "Background on PwC and audits" of our Submission and

	1991	Auditing Practices Board ("APB") established by the CCAB (replaces APC).	Response to Issues Statement dated 12 January 2012 and Annex 2 to that Submission. As regards changes to legislation, we believe the Working Paper should also address: • The underlying requirement for company statutory audit; • Provisions for statutory auditor appointment and removal; and • Statutory reporting obligations for statutory auditors (to whom the auditor reports, the form of reporting and the scope of matters on which the statutory auditor is required to report). Finally, the Working Paper should also include some analysis of the judgment in *Caparo Industries v Dickman* [1990] UKHL 2. (There is some overlap here with paragraphs 3.45 to 3.49 of the "Law and regulation" working paper, which we responded to on 4 May 2012, although neither paper deals with this case in any detail).
	1991	Introduction of UK Audit Regulations (subsequently revised 1995, 2008 and 2012).	
	1992	Cadbury Committee on the Financial Aspects of Corporate Governance publishes its report, including the first UK Code of Best Practice for corporate governance.	
	1998	First version of the Combined Code on corporate governance published, reflecting the Cadbury and Greenbury reports and the recommendations of the Hampel Committee (subsequently revised 2003, 2006, 2008, 2010 and 2012 - renamed the UK Corporate Governance Code from 2010).	
	2000	audit firms could become limited liability partnerships.	
	2002	EC Regulation on the application of International Accounting Standards.	
	2003	Smith Guidance published (subsequently revised 2008 and 2010 - renamed "Guidance on audit committees" in 2010).	
	2004	the Financial Reporting Council ("FRC") takes over responsibility for the setting of auditing standards through the APB; the FRC is also charged with monitoring and enforcing the auditing standards~~.~~; the APB finalises and issues five ethical standards (subsequently revised and reissued in 2010).	

	2005	APB elects to adopt the International Standards on Auditing (ISAs) developed and issued by the International Auditing and Assurance Standards Board ("IAASB") and develops International Standards on Auditing (UK and Ireland) (ISAs (UK and Ireland)) that include additional requirements and guidance for audits conducted in the UK to maintain the requirements of previous UK auditing standards and incorporate UK legislative requirements of auditors. APB also adopts IAASB International Standard on Quality Control 1 (ISQC 1) and developed ISQC 1 (UK and Ireland).	
	2006	Directive 2006/43/EC on statutory audits.	
	2006	the current consolidating Act was passed, giving effect to Directive 2006/ 43/EC; making it a criminal offence knowingly to issue a misleading audit report, but enabling auditors to agree a cap on liability with the company.	
	2008	the ~~Banking~~ banking crisis.	
	2008	Disclosure Rules & Transparency Rules chapter 7 on audit committees and corporate governance statements (i.e. elements of European Directives) implemented by the FSA.	
	2009	the APB issues new suite of auditing standards – ISAs (UK and Ireland) which adopt the clarity of ISAs of the International Auditing and Assurance Standards Board. One of the objectives of the IAASB's clarity project had been to make the ISAs more compatible with regulatory frameworks, including the EC's Statutory Audit Directive.	

	2010 The Audit Firm Governance Code is published. The Code sets a benchmark for good governance by the eight audit firms to which it applies, and is a Code which other audit firms may wish to voluntarily adopt. 2011 European Commission proposal for a regulation to increase the quality of audits of public-interest entities, and for a directive to enhance the single market for statutory audits. 2012 the APB is replaced by the Audit & Assurance Council, which now acts in an advisory role to the FRC Board which assumed responsibility for setting auditing standards; the AIU is reformed as the Audit Quality Review team under a new and expanded FRC Conduct Division; the FRC assumes responsibility for setting ethical standards aswell as auditing standards. 2012 FRC publish a consultation document on revisions to the UK Corporate Governance Code and Guidance on Audit Committees, which among other things, proposes the introduction of a 'comply or explain' requirement for FTSE 350 companies to put the external audit contract out to tender at least every 10 years.	
22	Among the major financial scandals of this period was the collapse of the bankers Overend, Gurney and Company in 1866 (with allegations of fraud and false statements made in the 1865 prospectus) and of the City of Glasgow Bank in 1878 (where massive losses had been hidden by falsified balance sheets and profit and loss accounts).	We question the relevance of these financial scandals, which as the Competition Commission notes concern allegations of false statements in a prospectus for the offering of shares, and the falsification of balance sheets and profit and loss accounts, in a working paper that is intended to cover the development of the statutory financial audit. Please can the Competition Commission explain why these scandals are relevant to this Working Paper.

25	The Companies Act 1900 was enacted 'with a view to the better prevention of fraud in relation to the formation and management of companies' [FN *Davey Committee report on Amendments necessary in the Acts relating to Joint Stock Companies incorporated with limited liability* (June 1895) (C 7779).] and this introduced a compulsory audit for most companies (but not banks) in terms similar to but not identical with those that had been in Table A under the earlier Acts.	Please note the amendment in the text which should read "not identical with".
31	In 1963 the Rolls ~~Razer~~ Razor collapse showed the limitations of the then current auditing arrangements to deal with the wide variations in accounting practices in use at that time. Rolls ~~Razer~~ Razor was a large scale supplier of domestic washing machines, but went into liquidation with liabilities of around £3.2 million, despite the last accounts showing net assets of around £1.6 million and profits of £400,000. Similar issues arose in 1967, in the contested takeover of Associated Electrical Industries (AEI) by General Electric Corporation (GEC). As part of its defence, AEI had forecast profits of £10 million for the current year, but once GEC had gained control, it transpired that AEI had a loss of £4.5 million.	Please note the amendment in the text as it should refer to Rolls Razor instead of Rolls Razer.
34	The Companies Act 1981 was enacted to give effect to the 4th Company Law Directive on the annual accounts of companies with limited liability. [FN 78/660/EEC of 25 July 1978, OJ (1978) L 222.] The Directive requires company accounts to follow prescribed formats for the ~~comprise a~~ balance sheet, ~~a~~ profit and loss account and the notes to the accounts.	We have amended the text of paragraph 34 to accurately reflect the changes implemented by the 1981 Companies Act (that gave effect to the 4th Directive). The requirement for the inclusion of a balance sheet, profit and loss account and notes predated this Act.
38	These provisions and the provisions of earlier Companies Acts, were subsequently consolidated in the Companies Act 1985.	We have marked up some suggested additional wording to paragraph 38 to make it clear that the Companies Act 1985 consolidated not only the provisions in the Companies Act 1981 (which required auditors to review the directors' report for consistency with the financial statements) but also the greater part of those Companies Acts that pre-dated it.
42	In 2000 the Limited Liability Partnerships Act was passed, which allowed the audit firms to become LLPs. ~~The circumstances in which this Bill was introduced were controversial~~	For the reasons explained in our overarching comments at the beginning of this response, we strongly disagree with the statement that "the circumstances in which this Bill was introduced were controversial" and request that this be deleted. In fact the LLPA bill

	~~In debate on the Bill, Austin Mitchell MP said that:~~ ~~The legislation's origins are very murky indeed. I should like to detail those origins because they are not based solely on a process of consideration ... The fact is that the big accountancy houses got into a panic ... because, as they have deep pockets, they felt vulnerable. They were afraid that people would make huge claims against auditors.~~ ~~The accountancy firms tried to panic the Conservative Government, who referred the issue to the Law Commission ... but it said that the firms could not have that special concession.~~ ~~The big audit firms then began another devious manoeuvre. They were so anxious to secure limited liability that they went to the Jersey legislature and tried to buy legislation on their own terms. It was drawn up by Slaughter and May and financed by what was then Price Waterhouse and by Ernst and Young at a cost of £1 million.~~ ~~That threat produced action. The Conservative Government began to draw up the legislation, we have continued with that. They did so under pressure from the big five and with a departmental civil service that works in what I would call close collusion – but let us say cahoots or a relationship – with the big accountancy houses.~~ ~~...the Bill is the result. [the 1989 Act] gave the accountancy houses the right to set themselves up as plcs if they wanted. They had been pressing for that, claiming that the fate of the accountancy profession depended on being given plc status. We gave them it, but only one accountancy firm took it up, converting its audit arm into a plc. Why do they not want to be plcs? Why do they want special limited liability partnership status?~~ ~~In 1991, the Institute of Chartered Accountants in England and Wales said that the obligation ... to publish their accounts is perceived as a considerable drawback. In other words, the firms want to keep their business to themselves. They do not want the partners to have to reveal their income. They do not want to reveal anything beyond the firm's total fee income. That is why they did not want to take up the offer of plc status. [FN HC Deb 23 May 2000 vol 350 http://hansard.millbanksystems.com/commons/2000/may/23/limited-~~	had broad cross-party support. In addition, we request that the quotation from Austin Mitchell MP be deleted as, while it appears that the Competition Commission is relying on this extract to support its statement that the LLPA bill was "controversial", the statement gives an entirely wrong impression of the extent of disagreement surrounding the bill - Mr Mitchell's view was a minority opinion and not representative of the debate in Parliament. Furthermore, a quotation of such length places undue emphasis on a topic that relates not to the development of statutory financial audit (which this Working Paper is supposed to cover), but to the evolution of audit firms.

	~~liability-partnerships-bill-lords.]~~	
43	In 2001 it became apparent that the Enron Corporation in the USA had been using specialized accounting techniques and special purpose enterprises to overstate profits and hide massive losses off balance sheet. Enron subsequently filed for bankruptcy. The Report of the Permanent Subcommittee on investigations of the Committee on Governmental Affairs, United States Senate [2002] [http://www.hsgac.senate.gov/download/the-role-of-the-board-of-directors-in-enrons-collapse.] found that: In 1999, Audit Committee members were given a nine page presentation on mark-to-market and fair value accounting issues, and told how Enron divisions were expanding their use of fair value accounting which 'require[d] continuous revaluation of asset[s] and liabilities' on Enron's books Andersen informed the Audit Committee members that Enron was engaged in accounting practices that 'push limits' or were 'at the edge' of acceptable practice. In the discussion that followed, Andersen did not advocate any change in company practice, and no Board member objected to Enron's actions, requested a second opinion of Enron's accounting practices, or demanded a more prudent approach. On paper, the Audit Committee conducted two annual reviews of LJM transactions in February 2000 and February 2001. [FN LJM were private equity funds which transacted business with Enron.] In reality, these reviews were superficial and relied entirely on management representations with no supporting documentation or independent inquiry into facts.	We consider that in paragraphs 43-49 there is a disproportionate level of detail about the US corporate failures of Enron and WorldCom. Consequently there is too great a focus on the legislative and regulatory developments in the US which followed on from those failures (e.g. the introduction of the Sarbanes-Oxley Act 2002, the creation of the PCAOB), and too little focus on the regulatory developments that followed in the UK (e.g. the FRC taking responsibility (through the APB) for setting standards for the independence, objectivity and integrity of auditors). This level of detail on the US developments is unhelpful and we suggest that they be deleted or significantly reduced in any revised draft of this Working Paper or in the Competition Commission's provisional findings.
44	The report included findings that: The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board	See comment in relation to paragraph 43

	witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates. The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor.	
45	On June 25, 2002, the US telecommunications company WorldCom announced that it intended to restate its financial results for all the quarters in 2001 and the first quarter of 2002 and filed for Chapter 11 bankruptcy protection the following month in what was the largest bankruptcy filing in the US to that date.	See comment in relation to paragraph 43
46	The US Securities Exchange Commission filed a complaint against the company for various breaches of the Securities Exchange Act of 1934 and claimed that WorldCom had misled investors from at least as early as 1999 through the first quarter of 2002, and that, as a result of undisclosed and improper accounting, WorldCom had materially overstated the income it reported on its financial statements by approximately $9 billion.	See comment in relation to paragraph 43
47	The response in the USA to these (and other financial scandals [FN Such as Tyco (where the former chairman and chief executive and the former chief financial officer were convicted of theft from the company, and Tyco settled a class action by agreeing to pay $2.92 billion, and its auditors agreeing to pay $225 million, to a class of defrauded shareholders).]) was adoption in 2002 of an Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes, sponsored by Senator Paul Sarbanes and Representative Michael G Oxley. [FN Public Law 107–204; Sarbanes-Oxley Act of 2002.]	See comment in relation to paragraph 43
48	The Act, among other things, created a private body with regulatory functions, the Public Company Accounting Oversight Board (PCAOB). Under section 101 of the Act the PCAOB has power (among other	See comment in relation to paragraph 43

	things) to: • register public accounting firms that prepare audit reports for issuers; • set auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports by issuers; • conduct inspections of registered public accounting firms; • conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms (including fines of up to $100,000 against individual auditors, and $2 million against audit firms); • perform such other duties or functions as the Board (or the SEC) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and their employees; and • sue and be sued, complain and defend, in its corporate name and through its own counsel, with the approval of the SEC, in any Federal, State or other court.	
49	~~More generally, the stated aim of the PCAOB is to 'protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports'.~~	We request that paragraph 49 be deleted in its entirety because we do not consider it is relevant to this Working Paper without a more developed analysis of the differences in the overall construct of the audit in the US and the UK.
50	In the UK the Companies (Audit, Investigations and Community Enterprise) Act 2004, placed new requirements on the five recognized supervisory bodies of auditors [i.e. ICAEW; ICAS; ACCA; ICAI; and the Association of International Accountants.] by making it a condition of recognition that they participate in independent arrangements for setting auditing standards relating to professional integrity and independence and setting technical standards; for monitoring audits of listed companies and other companies whose financial condition is of particular importance; and for investigating and taking disciplinary action in relation to public interest cases.	We refer to our comments on paragraph 4 above. In our view, the introduction of the Companies (Audit, Investigations and Community Enterprise) Act 2004 is just one example of legislative history that relates to the roles of the professional bodies. The Working Paper currently lacks any explanation of how the roles of those professional bodies have developed over time and their relationship to the developments in audit regulation, including the role of the FRC, referred to in relation to our response to paragraph 51.

51	The Act also enabled funding to be provided to the FRC for setting accounting and auditing standards (through the ASB and the Auditing Practices Board (APB)); for enforcement or monitoring (through the Financial Reporting Review Panel Ltd (FRRP)), the Accountancy Investigation and Discipline Board (AIDB), and the audit inspection unit reporting to the Professional Oversight Board for Accountancy (POBA)); and for oversight of the major professional accountancy bodies (through the POBA). Under the FRC Reforms, approved by the Government during 2012, there have been significant changes to the FRC's operating structure and a number of the above-mentioned bodies have been superseded or re-organised.	In line with our comment in relation to paragraph 50 above, the reference to a specific piece of legislation that impacted the role of the FRC raises questions about the history and role of the FRC. In our view, these areas should also be included in the Working Paper. (There is an overlap here with section 5 ("Regulatory bodies and mechanisms") of the "Law and regulation" working paper dated 20 April 2012, which we responded to on 4 May 2012, and which provides much of the necessary context.) We have amended paragraph 51 to include some additional text to refer to the FRC Reforms of 2012 which have now been approved by the Government. (There is an overlap here with paragraphs 5.79-5.82 working paper on "Law and regulation"). The FRC now operates through two main committees: Codes and Standards; and Conduct. These committees have taken on many of the responsibilities of the previous bodies, while strategic decision-making is now undertaken by the FRC Board. On the disciplinary side, the FRC is in the course of consulting on various changes to its Disciplinary Schemes.
53	In 2006, to deal with the issues raised by Enron and WorldCom [FN In the USA this was done by the Sarbanes–Oxley Act of 2002 (Pub.L. 107–204, 116 Stat. 745)] and by the Parmalat scandal in Europe, the EU replaced its 8th Company Law Directive with a revised version of the Directive. [FN 2006/43/EC (replacing the Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents) OJ (2006) L 157/87.] The Directive aims at a high-level (though not full) harmonization of statutory audit requirements and largely reflects best practice for statutory audit as already existed in the UK at that time. These provisions have been given effect by the Companies Act 2006 in the UK.	We have amended the text in paragraph 53 to add some additional wording to make it clear that the revised version of the Directive largely reflected existing best practice for statutory audit in the UK at the time.
54	The Audit Directive expands and replaces the Eighth Council Directive on Company Law (which only dealt with the approval of statutory auditors) by clarifying the duties of statutory auditors, their independence and ethics; by introducing a requirement for external	We request that the additional text we have marked up in relation to paragraph 54 is added at the end of the paragraph.

	quality assurance; and by ensuring public oversight over the audit profession, most of which had already been in place in the UK.	
55	The Directive~~s~~ clarifies that a group auditor bears full responsibility for the audit report on the consolidated accounts of the company, a principle that had long been reflected in UK auditing standards. As regards 'public-interest entities' (ie listed companies, banks and insurance companies) the Directive requires that the audit committee must monitor the effectiveness of the company's internal control, internal audit (where applicable) and risk management systems. Also, only non-audit practitioners can participate in the governance of the system of public oversight of the auditors of public-interest entities.	We request that our additional wording is added to the first sentence of paragraph 55 to make it clear that although the Directive clarifies the responsibility of the group auditor, in the UK the principal auditor has always had sole responsibility for the audit opinion on group financial statements.
56	Auditors must have knowledge of the relevant ~~international~~ accounting standards on which the financial statements have been prepared ~~(IAS)~~ and international auditing standards (UK and Ireland) (ISA~~)~~ (UK and Ireland)). In the case of public interest companies~~, the audit committee must appoint the statutory auditor or audit firm, and~~ the audit committee is involved in the selection of the statutory auditor to be proposed to the members for appointment; the statutory auditor or audit firm must report to the audit committee on key matters arising from the statutory audit, ~~particularly~~ including ~~on~~ material weaknesses of the internal control system in relation to the financial reporting process. ~~Any t~~Threats to the auditor's independence must be disclosed to and discussed with the audit committee, and the auditor must confirm his independence in writing to the audit committee.	We request that our suggested marked up amendments be made to paragraph 56 so that it accurately reflects the following: 1. Under Article 41.3 of Directive 2006/43/EC, the appointment of the statutory auditor may still be proposed by the board or the supervisory body, but based on the recommendation of the audit committee. 2. Under Article 41.4, the auditor's obligation to report in relation to weaknesses in internal control is in relation to the financial reporting process, rather than an open-ended obligation in relation to all such weaknesses. 3. Under Article 42.1(c) the reference is to discussing with the audit committee threats to independence – the word "any" is not used.
57	Member States must ensure that adequate rules are in place which provide that fees for statutory audits are not influenced or determined by the provision of additional services to the audited entity. In the UK these rules have been implemented by means of detailed ethical standards issued by the Auditing Practices Board. ~~set rules for audit fees that ensure audit quality and prevent 'low-balling' (ie offering the audit service for a marginal fee and compensating this with the fee~~	We request that the wording in paragraph 57 be replaced with the wording of the Directive 2006/43/EC Article 25(a) (as marked up) so that it is more accurate.

	~~income from other non-audit services).~~	
58	Article 31 of the Audit Directive invited the European Commission to present a report on the impact of current national liability rules for carrying out statutory audits on European capital markets. Following an independent study 'Study on the Economic Impact of Auditors' Liability Regimes', September 2006: http://ec.europa.eu/internal_market/auditing/liability/index_en.htm. and a consultation, the European Commission published a recommendation in 2008 Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms, OJ (2008) L162/39. http://eur-x.europa.eu/JOHtml.do?uri=OJ:L:2008:162:SOM:EN:HTML. that the civil liability of statutory auditors, and of audit firms, arising from a breach of their professional duties should be limited, except in cases of intentional breach of duties by the statutory auditor or audit firm. In the UK, the Companies Act 2006 introduced the concept of "limited liability agreements" which may be agreed between the auditor and the members (shareholders) of the company to limit the auditor's liability.	We request that our suggested additional wording at the end of paragraph 58 be added to the paragraph to make it clear that the concept of limitation of audit liability has been implemented in the UK by the Companies Act 2006.
59	The banking crisis in 2008 provided lessons for all involved, including audit firms. ~~highlighted that considerable shortcomings remained in the audit system. Tt~~The crisis was a consequence of a distinct and largely unanticipated set of highly unusual circumstances including ~~Notwithstanding~~ serious intrinsic weaknesses in the financial health of the relevant companies~~,~~. ~~the audits of those companies, carried out immediately before, during and following the crisis, had resulted in 'clean' audit reports~~	We request that our suggested amendments to the wording in paragraph 59 be made to the paragraph because it is incorrect to suggest that the banking crisis highlighted shortcomings in auditing. While the crisis had lessons for all involved, this does not enable the Competition Commission to draw the conclusion that the crisis showed that there was a failure of the audit or that it demonstrated a failure in the competitive process for audit services. We have made this clear in paragraphs 1.22-1.25 and 2.56-2.57 of our Submission and Response to Issues Statement dated 12 January 2012 and in our Response to Certain Third Party Submissions dated 6 August 2012 (at section 3 where we set out our view on audit and the financial crisis). This subjective conclusion is also not consistent with the House of Commons Treasury Committee Report in to the collapse of Northern Rock which stated: "*We have received very little evidence*

		that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient." Furthermore, the vast majority of companies did not fail during the financial crisis and robust audits were a key contributor to that (see page 1, Hundred Group Submission of 6 April 2012): *"The vast majority of companies, both in the UK and in the rest of the EU remained strong during the recent financial crisis, and indeed weathered the very difficult economic conditions admirably. Inevitably certain sectors fared less well than others: However to predicate a significant and wide ranging reform on these isolated examples is to ignore the fact that in the vast majority of cases, the role and effectiveness of independent auditors has not been, and should not be, called into question. Even within the most adversely affected sectors, there is no evidence that particular audit firms performed better or worse than others".* In addition, there is evidence from investors that they agree with this view. The BlackRock case study states *"The Investors did not hold auditors accountable for issuing unqualified going concern opinions in advance of the banking crisis... The banking crisis arose for many reasons and audit was only a part of that"* (paragraph 33 BlackRock case study). The Legal & General Investment Management case study states: "*The Investor did not blame auditors in general for the banking crisis*."
60	In November 2011, the European Commission issued a proposal for a regulation to increase the quality of audits of public-interest entities, and for a directive to enhance the single market for statutory audits. Key elements of these proposals (which are controversial and may be subject to change and modification before any final approval) ~~are~~include: (a) Mandatory rotation of audit firms: (audit firms required to rotate after a maximum engagement period of six years (with some exceptions). A cooling off period of four years is applicable	We request that our suggested additional text be inserted into paragraph 60 to acknowledge the fact that the proposals have proved to be controversial, and may well be subject to change and modification before any final approval. In addition, the word "are" should be amended to be "include" because the key elements listed do not necessarily comprise all of the key elements of the proposals, but only some of them.

	before the audit firm can be engaged again by the same client. The period before which rotation is obligatory can be extended to nine years if joint audits are performed). (b) Mandatory tendering: (public-interest entities obliged to have an open and transparent tender procedure when selecting a new auditor; the audit committee to be closely involved in the selection procedure). (c) Non-audit services: Audit firms prohibited from providing non-audit services to their audit clients. In addition, large audit firms obliged to separate audit activities from non-audit activities in order to avoid all risks of conflict of interest. (d) European supervision of the audit sector: (coordination of auditor supervision activities to be within the framework of the European Markets and Securities Authority).	