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**BY POST & E-MAIL**

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Dear Julian

**CHOICE IN THE UK AUDIT MARKET  
INTERIM REPORT OF THE MARKET PARTICIPANTS' GROUP**

We are grateful for the opportunity to comment on the provisional recommendations proposed by the Market Participants' Group ('the Group').

Standard Life investments is a leading global investor, managing assets of approximately £137 billion as at 31 March 2007. In fulfilling our responsibilities, we place considerable reliance upon audited financial information to assist us in decision-making and stewardship. Accordingly, as expressed in previous letters to the Financial Reporting Council ('FRC'), we are concerned about the level of auditor concentration and the potential consequences of one of the Big 4 firms ceasing to provide audit services. Therefore, we welcome the FRC's initiative in convening the Group. We take this opportunity to convey our appreciation and thanks to its members.

**Introduction**

With one very important exception, which relates to the suggestion that companies should consider seeking shareholder approval of their audit committee report, the Group's provisional recommendations enjoy our support. Therefore, we look to the FRC to provide strong, unambiguous and assertive leadership when and after the final recommendations of the Group are published in order that those market participants who will be responsible for implementing the recommendations are given encouragement to do so with a sense of urgency and purposefulness. Also, we ask that the FRC and the Group give careful consideration as to the standing and authority of the final recommendations – for example, will they comprise a stand alone document or will they be incorporated, directly or indirectly, into existing pronouncements? It may be appropriate in due course to undertake an informal consultation with the main representative bodies in this regard.

**Comments on Provisional Recommendations**

- (1) *The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules subject to there being sufficient safeguards to protect auditor independence and audit quality.*

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We support this recommendation.

We note the European Commission has commissioned a study on ownership rules applying to audit firms and the consequences these rules have on audit market concentration. It would seem sensible for the FRC to plan its promotional activities such that they can be informed by the study and enjoy any benefits accruing therefrom.

In evaluating the provisional recommendation we noted that:

- The changes to ownership rules would result in changes – arguably improvements – to the corporate governance of audit firms.
- Changes to audit firm ownership rules may encourage more competitive differentiation between the firms which, in turn, may enhance confidence in audit quality standards.

- (2) *Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.*

In principle we support the provisional recommendation but we remain to be convinced that such information will be a key determinant in encouraging new entrants.

- (3) *In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.*

We support the substance of the provisional recommendation but we question whether ‘legislators’ have a responsibility for seeking to promote audit choice.

Whenever possible, the promotion of audit choice should be achieved by market forces rather than by legislation.

- (4) *Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms.*

We support the provisional recommendation.

- (5) *The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency of the capabilities of individual audit firms.*

We support the substance of the provisional recommendation.

Whilst the FRC has a role to promote such greater transparency, we suggest that the provisional recommendation be strengthened by recommending that auditors of publicly listed companies should systematically engage investors in order to improve their understanding of the capabilities of the firm concerned and to help foster an appropriate dialogue between investors and individual audit firms.

- (6) *The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.*

We support the provisional recommendation.

If it is not already the case, the quality and timeliness of information provided to the incoming auditor should be included within the scope of regulatory reviews of individual audit firms.

- (7) *The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.*

We tentatively support this provisional recommendation but we should welcome wider discussion of the risks arising from the use of firms from more than one audit network. We are concerned to ensure that this provisional recommendation, of itself, does not unintentionally increase the risk of audit failure.

- (8) *The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.*

We support this recommendation, noting for emphasis that the Smith Guidance is guidance as such and not a requirement. We recognise the comments in the consultation document that imply that companies generally provide insufficient information for investors to make an informed decision regarding auditor selection. However, we are concerned that the guidance will merely result in unhelpful boiler-plate disclosures. Consideration should be given by the Group as to how this will be prevented.

- (9) *When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.*

We support the provisional recommendation with the proviso that disclosure should be made of any relevant contractual – or quasi-contractual – obligation that influences the appointment of an audit firm. This information will assist shareholders understanding of the auditor selection decision context and enhance their appreciation of relationships and arrangements which might be relevant to the company's governance.

- (10) *Investor groups, corporate representatives and the FRC should develop good practices for shareholder engagement on auditor appointment and re-appointments and should consider the option of having a shareholder vote on audit committee reports.*

We support the provisional recommendation relating to the development of good practices for shareholder engagement. However, we oppose the recommendation that consideration be given to the option of having a shareholder vote on audit committee reports. In our submission to the FRC in relation to its Discussion Paper of May 2006 we stated that:

'It has been suggested by some commentators that the audit committee report should be subject to an annual advisory vote by shareholders. We considered this suggestion but concluded that it would be inappropriate, inefficient and ineffective. We question:

- Whether such a vote would improve the quality of reporting by audit committees. Indeed, it might encourage audit committees to adopt a boiler plate reporting style, which would be a retrograde development; and
- Whether such a vote and the anticipated incremental engagement would contribute to the objective of achieving increased choice in the UK audit market.

Last but not least, we are concerned that such an advisory vote might encourage institutional investors to micro-manage the board and audit committee policies and practices to a degree which is undesirable and inappropriate.'

Our views remain unchanged, indeed, if anything, the passage of time has tended to strengthen our opposition to having a shareholder vote on audit committee reports.

The provisional recommendation has been carefully drafted to recommend that relevant parties 'should consider the option' of such a vote. We note the latitude provided by such wording but we are extremely concerned that, notwithstanding, any pronouncement by the FRC, directly or indirectly, which refers in such terms to a shareholder vote of audit committee reports will inevitably be regarded as 'best practice' by market participants. In addition, the commentary on and the evaluation of the provisional recommendation, as set out in the Consultation Document, fails to recognise the wider and very significant adverse consequences of a shareholder vote on audit committee report for corporate governance in the UK. In particular, such a vote could undermine the unitary board responsibility for the financial aspects of corporate governance. Also, the risks of destabilising the well-balanced and well-respected corporate governance environment which exists in the UK by having such a vote should not be underestimated.

- (11) *Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.*

We support the provisional recommendation.

- (12) *The FRC should review the independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.*

We support the provisional recommendation.

- (13) *Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.*

We support the provisional recommendation but in the interests of protecting audit quality it is vital that the protocols developed by regulators should recognise that situations may arise when very serious issues may necessitate a regulatory response which would call into question the sustainability of the audit firm in question and its ability to continue to provide audit services.

- (14) *Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.*

We support the provisional recommendation.

You invite comment on what adaptations to the Combined Code, if any, might be appropriate. Bearing in mind that the Combined Code is based on a 'comply or explain' approach we would have no problem in principle of the Combined Code being applied in this context without adaptation such that the firms explain why they do not comply with the Code's provisions. On this basis the FRC might undertake to review the degree of compliance with the Code and its consequences after, say, three years with a view to ascertaining whether or not the provisional recommendation is achieving its objective. As mentioned previously, a change in ownership rules may provide a catalyst for governance change.

- (15) *Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.*

We support the provisional recommendation. We question whether the recommendation should relate to all entities within the scope of the Turnbull guidance as opposed to just 'major public interest entities'.

### Conclusion

There is clearly no quick-fix to achieve the objective of improving choice in the UK audit market. However, we do not underestimate the risks to capital markets and wealth creation if one or more of the Big 4 audit firms ceases to provide audit services. That said, all market participants must uphold their principles in the event that tough decisions have to be taken in order to respond to serious audit failures.

We support the FRC in its quest for solutions to improve the status quo. In this regard, we trust that our comments will assist the Group in developing its final recommendations.

Yours sincerely

Guy R Jubb  
*Investment Director, Head of Corporate Governance*  
*Standard Life Investments*

cc. Mr P Boyle – Chief Executive, FRC and Group Convenor  
Mr P George - FRC