

EXTERNAL AUDIT



AUDITORS GO ON THE DEFENSIVE

Auditor of the Year



AUDIT ■ TAX ■ ADVISORY



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Game plan

There is nothing so constant, they say, as change – and this certainly applies to the audit market. It may be a good few years since the scandals of Enron and WorldCom, but the repercussions are still being felt.

The collapse of Andersen ushered in the era of the Big Four, which has pushed hard to gain greater protection against the same fate befalling one of them. This in turn has led to fears that choice at the top end of the market is severely limited and calls for ways to open it up to more players. This is without mentioning the introduction of wave after wave of regulations and corporate guidelines that have permanently altered the relationship between auditor and client.

A company's audit committee has more power and more responsibility than ever before and lead audit partners cannot stay with the same client for long periods of time.

Soon companies will be negotiating with their audit providers over the limitation of the firm's liability to its client, while the firms themselves face new threats from a new type of legal action.

This briefing will help you untangle the complex web that audit has become. We give you the latest information on the audit choice debate, show you how to switch audit partners in the smoothest way possible, or even change audit firms without too much pain.

If you're looking for advice on how to negotiate your limited liability agreement, you can find it within these pages, along with much more on the current state of the audit market.

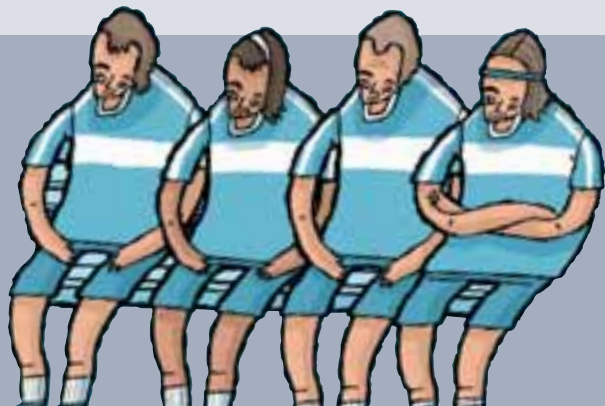
It's the information you need right now to help make the best decisions. But in six months time, given the nature of the audit market, it could all be changing again.

Paul Grant, Editor

Soon companies will be negotiating with their audit providers over the limitation of the firm's liability

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Open goal

The Financial Reporting Council is looking at ways to increase choice in the audit market, following concerns that the Big Four's stranglehold on the top end of the market could hurt audit quality. It has come up with 15 proposals with a final report due in October. But what are they and how will they affect FDs choosing auditors? Alex Hawkes explains

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.

EXPLANATION: The regulator is trying to open up the ownership of audit firms. Accountancy firms are generally required under law to be run by qualified auditors. The FRC believes that private equity or other forms of investment might ensure that there is greater choice.

IMPACT: Unlikely to have much impact for some time. If, and when, a privately funded challenger did charge on to the scene, then FDs could decide whether to switch.

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

EXPLANATION: Auditors should declare their profitability. This is intended to encourage other types of investment to come to the market.

IMPACT: As with opening the market to private equity, it's too early to predict its impact. It's worth noting that the Big Four already tell us how profitable audit is. Only recently, Deloitte said it had made £146m profit on audit revenue of £557m.

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.

EXPLANATION: Audit choice should be important to regulators, but not so important that it overrides quality.

IMPACT: Practically nil – it's difficult to see what this adds to the debate. The audit quality clause has clearly been added by Big Four lobbyists whose argument is that audits are already excellent.

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

EXPLANATION: Bodies like the IASB should try and shed the image they give of being dominated by Big Four alumni.

IMPACT: Could be significant. The standards-setters do have a problem, with the allegation broadly accurate. This will cause a fuss, and ideally some momentum towards accounting standards that are simpler, and do not require the likes of a Big Four audit partner to understand.

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.

EXPLANATION: The FRC has been criticised for producing bland statements about audit quality when inspecting the Big Four. It is up to the Professional Oversight Board, an arm of the FRC, to say when a firm has made a mistake.

IMPACT: The POB is already implementing this by producing individual audit reports. As far as FDs are concerned, this information will be invaluable.

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.

EXPLANATION: KPMG suggested that incoming auditors should be able to access the outgoing auditors audit files. That way, they can get up to speed more quickly, and FDs and others will be keener to switch since it will be much less hassle.

IMPACT: Potentially significant, but Ernst and Young has said that changes to file access would have a 'limited impact' on choice as much accumulated knowledge is not written down.

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.



EXPLANATION: This relates to calls for joint audits, which in France have seen a much greater choice in the audit market.

IMPACT: Joint audits are a real hot potato. Mazars, which has huge experience in France, is backing them. Big Four sources say that the move is a recipe for trouble – Parmalat was joint audited, they point out.

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 re-selection decision.

EXPLANATION: Companies should say why they are re-electing their auditor

IMPACT: This will have a very real impact on companies as it is yet another regulation. Very few say why they are re-electing their auditor, and it would be interesting to know why many favour the incumbent so often.

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



EXPLANATION: There are fears from mid-tier firms that some potential clients are told by their bankers or others to hire a Big Four auditor.

IMPACT: If that is the case, then this may stop it. The idea is to flush out and expose institutional prejudices.

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.

EXPLANATION: Directors choose the auditor, but audits are ultimately conducted for investors and others, who should have role in deciding who the auditor is.

IMPACT: There's little evidence that more than a handful of investors are interested in engagement on these issues, and suggestions that investors might sit on the audit committee are perhaps impractical. Apart from anything else, committees have inside information unavailable to the market.

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.

EXPLANATION: Auditors could be prevented from carrying out non-audit work for their audit clients.

IMPACT: This could potentially open up some non-audit work to others, but it is phrased very vaguely, since it could be contentious. Don't expect anything soon.

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.

EXPLANATION: As with (11), but for the FRC.

IMPACT: As with (11).

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

EXPLANATION: There are worries that in serious cases of misconduct, the market does not know whether the firm is likely to collapse as a result.



IMPACT: This is more of a damage limitation issue for firms. It won't have an impact on other companies unless something goes seriously wrong at their auditor's firm.

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.

EXPLANATION: The firms should be open and transparent with investors.

IMPACT: The Combined Code tells companies to communicate with investors about corporate governance, and 'comply or explain.' But as one Big Four source says, in relation to the fact that Big Four partners already own their firms, 'who would we comply or explain to?' May not make the cut.

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.

EXPLANATION: Companies should have a contingency plan if their firm goes under.

IMPACT: Not huge. Companies can hire another firm, as long as the choice is there.



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Off the bench

How can audit committee's continue to attract high-quality signings? asks David Jetuah

According to recent regulatory guidance, the audit committee must be prepared to take a robust stand, and all parties must be prepared to make information freely available to the audit committee, to listen to their views and to talk through the issues openly. But how realistic is this in practice?

Out on a limb

An audit committee that meets the job specifications required (see box) only achieves part of its function. When push comes to shove, will it stand its ground when it disagrees with the executive board, or fall meekly in line?

As there is now a dedicated section of a company's annual report set aside to describe the work of the audit committee, some argue that the body now has an authority it might otherwise lack. But while management is under an obligation to ensure the audit committee is kept properly informed, in practice the situation might not be so rosy.

Gerald Russell, Ernst and Young's London senior partner and director of the firm's NED programme, warns that candidates are shying away from the high-maintenance roles, because the requirements are unrealistic.

'Part of the answer may be more thought about the level of support needed by the audit committee chairman from the internal and external auditors. The expectation that audit committee chairmen have to know everything has to change,' says Russell. 'It may be there should be regulatory recognition that it is naïve to believe the audit chairman has more knowledge or expertise than the CEO: the role is to chair the committee, not assume command of all risk.'

Too close for comfort?

With the onset of the beefed-up Combined Code, the governance minefield has become even more treacherous for audit committees. One key point covers the employment of former employees of the external auditor, paying particular attention to the policy regarding former

employees of the audit firm who were part of the audit team and moved directly to the company.

So the appointment of Chris Lucas as Barclays FD, formerly the engagement partner of external auditor PwC, must be something of a headache for its audit committee. Even after he served the requisite buffer period between the two roles, critics question whether auditor independence can be guaranteed when the FD has such close links with the firm?

Toeing the line

Audit committees have to negotiate a razor-thin path in discharging their mandate and it's easy to see where clashes can occur between committee, board and auditor. They should, for example, satisfy themselves there is a proper system and allocation of responsibilities for the day-to-day monitoring of financial controls, but they should not do the monitoring themselves.

Co-author of the Combined Code Sir Robert Smith makes it clear that companies need to be pro-active in their dealings with the audit committee: 'Audit committees have wide-ranging, time-consuming and sometimes intensive work to do. Companies need to make the necessary resources available. This includes suitable payment for the members of audit committees. They – and particularly the audit committee chairman – bear a significant responsibility and they need to commit a significant extra amount of time to the job.'

Every committee and every company is unique, but Russell puts particular emphasis on clarification of the chairman's role if the situation is to improve. 'Without more clarity, the perceived risks of taking the job will become a disincentive outweighing the benefits, thereby leaving a dangerous vacuum at the heart of corporate governance,' he says.



The job spec

With regards to the board and independent auditors, the audit committee's role entails:

- monitoring the integrity of the financial statements of the company and announcements relating to the company's financial performance;
- making recommendations to the board for it to put to the shareholders for approval at AGMs, eg. appointment of the external auditor and its remuneration;
- reviewing and monitoring the external auditor's independence and objectivity, and the effectiveness of the audit process; and
- developing and implementing policy on the engagement of the external auditor to supply non-audit services.

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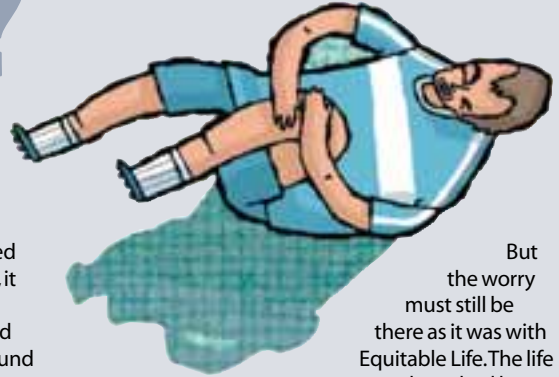
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Litigation funded by third parties could put auditors out of business, writes Alex Hawkes

Foul play?



Auditors, long seen as having the deepest pockets by litigants looking to recover cash from collapsed businesses, are facing a new threat. Previously, liquidators could pursue a court action against a former auditor, only if they had enough money for what are generally very costly cases. But more cases against auditors look set to be brought in the future by litigants funded by third parties that hope to get a share of the damages.

The case that has set the cat among the pigeons concerns Moore Stephens and an action brought by former client Stone & Rolls, now in liquidation.

S&R claims that Moore Stephens failed to pick up fraud at the company, and has the financial backing of IM Litigation Funding to pursue the claim.

The claim was initially for as much as £90m. An award of that magnitude could cripple Moore Stephens, which has a turnover of just over £100m.

On the attack

'This case illustrates the growing trend of seeking to blame auditors for the results of fraud in companies. In that context, litigation funding is a concern to auditors and their professional indemnity insurers,' says Peter Ellingham, a partner at City law firm Kennedys.

'On the one hand, no one would suggest it is fair that a bona fide claim should be constrained by a lack of funds. On the other, in general terms, and with no reflection on the specifics of this claim, there is an inevitable concern when an action is funded by a third party with a purely financial interest in the outcome,' he argues.

There is, however, some good news for auditors. The case has already been

through preliminary hearings, and though Moore Stephens had hoped to get the claim struck out, it has succeeded in at least limiting it. Stone & Rolls had hoped to claim for compound interest.

Lawyers for the bankrupt firm argued that losses that were caused by the fraud had had to be made good with debt, and that therefore the nature of the loss meant compound interest was justified.

The trial judge said that the compound interest portion of the claim appeared to be from 'cloud cuckoo-land,' and dropped it. That reduced the claim by about £40m. And, in the broader framework, it is still early days.

Peter Wyman, head of professional affairs at PricewaterhouseCoopers, says that he knows of no other claims that are being brought. 'It's potentially very concerning,' he says. 'But it's early days. Certainly [at PwC] I'm not aware that we have had any potential litigation that has arisen because somebody is offering to fund it.'

Possible replay

There is only one case in play, but IM Litigation Funding was said to have looked at hundreds of possible actions before deciding on Stone & Rolls. The worry is that this claim is the tip of the iceberg, and if this case is successful, others will surely follow.

Wyman thinks we should stop seeing auditors as deep pockets. He argues that if firms do start going under as a result of claims, then auditors will cease to become such attractive targets.

But the worry must still be there as it was with Equitable Life. The life assurer launched huge claims against former auditor Ernst & Young and its former directors.

While some of the directors were millionaires, it was certainly no honey pot.

The largest auditors, on the other hand, turn over £2bn a year, and are reckoned for that reason to be juicier targets. Pleading that they do not have deep pockets is probably unlikely to convince potential litigants.

As for the case itself, a further hearing is expected early in the New Year, where more details of Moore Stephens' alleged negligence will be thrashed out. Commentators will also want to argue that success on the part of Stone & Rolls could be damaging in many other ways.

Whatever happens, it's fair to say that Moore Stephens won't be the only ones fretting on the outcome.

There is an inevitable concern when an action is funded by a third party with a purely financial interest

Unsporting behaviour

The case against Moore Stephens is not just worrying some because it threatens to bring more cases against auditors – but also because it may be a threat to what is perceived as a British way of doing business.

'I got back from New York this morning. Every time you are there you are reminded of the unhealthy litigation culture. We could go down that road,' says Peter Wyman of PricewaterhouseCoopers.

'What worries me about litigation is that it creates a broader defensiveness. Directors and auditors thus become less useful.'



Making **quality** decisions

When companies consider changing auditors, one thing none of them wants to compromise on is audit quality. But anyone who thinks that delivering high quality audits is the sole domain of the Big 4 should think again.

The audit market – in particular for large, listed companies and other public interest entities – is dominated by a small number of massive players. However, the perception that only the ‘Big’ players can provide high-quality audits on a global basis is simply not true. Although there is no one, clear definition of a quality audit, there are several generally acceptable drivers behind it: the culture and leadership of the audit firm; the skill and experience of its audit partners and staff; and the quality of its audit processes. Mazars delivers in all these areas.

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Tactical substitute

Audit rotation needn't be daunting if you plan well in advance, writes Tim Gordon

Listed companies in the UK are facing up to the implications of audit partner rotation – the fact that their friendly senior auditor suddenly has to move on. The Auditing Practices Board's ethical standard (ES3), specifies that the audit engagement partner must rotate every five years.

Gradually, but with increasing frequency since December 2004 when ES3 became effective, audit partner rotation has been impacting on listed companies, whose audit committees now need to plan ahead for these transitions. For non-listed companies, where the relationship between auditor and company is often much closer, the rotation periods are longer, but the issue can be just as critical.

Try-outs

As the first rotation cycle evolved, it became clear that there were challenges to be addressed on both sides to make it work smoothly and effectively.

Companies have generally found the process to be effective, welcoming a fresh approach, new insight and ideas. But, at the same time, companies want to retain knowledge of their legacy decisions when their audit partner rotates out. In addition they want stability around advice and policies.

Problems have occurred when clients have not felt engaged in the process and

therefore feel they have not 'chosen' their new partner, or where issues they felt had been dealt with were either revisited or overturned. In the worst case, badly planned rotations have led to further partner changes and even re-tenders. To avoid disruption, it is therefore important that a proper handover is achieved and clients are given an opportunity to ensure that the chemistry will work.

There is no one-size-fits-all process and the range of approaches depends on the size of the company and the importance it places on the audit.

In one company, it was just two months before the year-end that the CFO, the audit committee chair and the CEO made their decision after interviewing one of two potential candidates.

In another case, the audit committee chair and the CFO interviewed two candidates and made their decision a full six months before year-end, leaving plenty of time for a proper handover between the outgoing and incoming partners.

Talking tactics

Audit firms seeking to meet the needs of large clients are identifying in advance those partners for rotation with relevant sector, industry, and large client handling experience; all skills which, for a large audit, may already exist within the team.

Leading audit firms recognise the need

for a matching exercise so that the new partners earmarked to rotate in to an audit have just as good a relationship with key individuals in the client company.

Partner rotation is being planned years ahead, giving companies the opportunity to

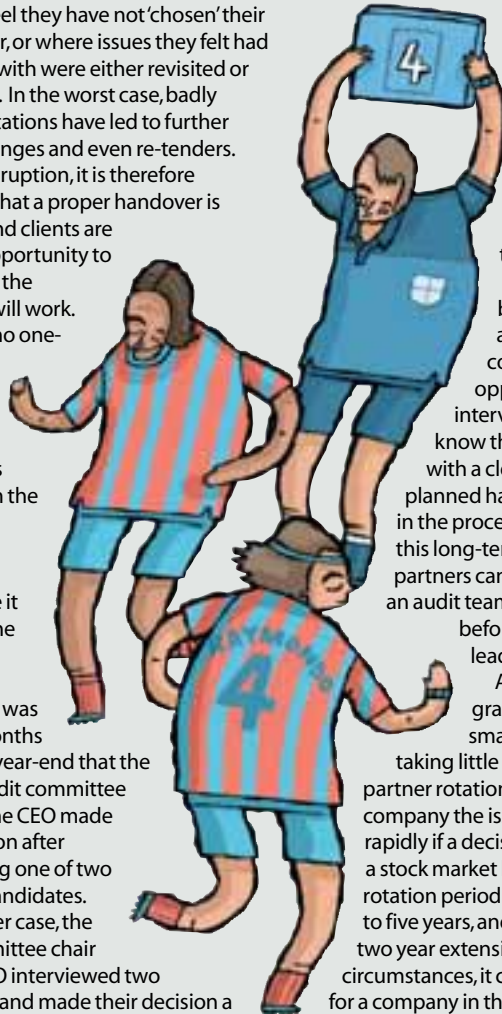
interview and get to know the new partners, with a clearly staged and planned handover embedded in the process. As an example of this long-term planning, partners can be removed from an audit team for two years

before coming back to lead the engagement.

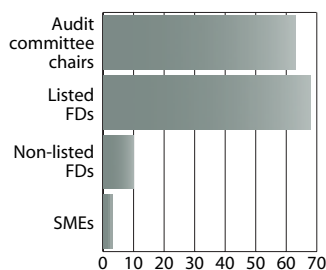
An APB survey (see graph) indicates that smaller companies are taking little account of audit partner rotation, but for a small company the issue could arise rapidly if a decision is made to seek a stock market listing. Suddenly the rotation period diminishes from ten to five years, and although there is a two year extension available in these circumstances, it can still be a shock for a company in the midst of listing requirements to be told its trusted adviser is going to have to change.

Companies and their auditors are still in the first cycle of audit partner rotation, and there is a risk that companies under-estimate the impact of a badly managed transition. But leading companies and their auditors are developing best practice which addresses the issues, offering an agreed process to smooth the transition.

Tim Gordon, is managing partner, Ernst & Young London Assurance



Proportion of respondents reporting rotation of key audit partners (%)



source: APB April 2007

Blurb, blah,
stuff about numbers, figures,
blah blah, cough, **something about ROI,**
blah blah, waffle, more waffle, super-waffle,
the king of all waffle, **something**
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and loss, yawn, blah blahdee blah
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the score

As the debate over audit choice prepares to go into extra time, with final proposals due in October, auditors look set for a change of tactics. From next April, they will be able to boost the defence of a multi-billion pound service line (the Big Four alone take **£2.5bn** in revenues from audit – **40%** of their total fee income) by negotiating liability limitation agreements with clients. This will curtail their exposure to risk from future negligence claims but could cause a rearguard action from shareholders. However, these agreements may be needed to fend off the counter-attacks of litigation funding companies appearing out of leftfield in a hope of bagging a slice of the claims pie. Moore Stephens is one firm that could be **£90m** down by the final whistle.





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Seeing red

Businesses and auditors need to find common ground on limited liability agreements, to prevent future disagreements having a catastrophic effect, writes Kevin Reed

When businesses negotiate terms and conditions with professional services firms, such as accountants, the service provider will usually look to limit its exposure to the risk of huge claims arising from its work.

Tax specialists, in particular, have looked to limit the risk of litigation surrounding their advice, following some huge lawsuits in the US.

So far, the law in the UK has stopped auditors from contractually limiting their level of exposure to claims, but that is about to change.

From 6 April 2008, as a result of the Companies Act, the law will change to allow auditors to calculate and seek agreements with clients to limit their liability.

Auditors have sought this ability for years, and the issue was brought into sharp focus following the collapse of Enron and its auditor Andersen. This has proved controversial, as losing a litigation case was not what caused Andersen to collapse. Yet the fear of another large audit firm going to the wall and the potentially devastating impact that would have on the market has forced the government's hand.

Limited liability agreements will soon be a fact of life for businesses requiring an audit.

'They will have auditors knocking on their door soon,' warns Tony Bromell, head of accounting markets and ethics at the ICAEW.

So, what should companies expect from the new arrangements? How should

discussions be handled? And what power does a company really have to ensure that the terms of the deal are acceptable to its shareholders?

Ready to kick off

Bromell says firms will soon start asking their clients about how to formulate limited liability. And, in some cases, tentative discussions have already begun. Reports have already surfaced of discussions between BP, Tomkins and their respective auditors.

'The subject can be broached at any time now,

regulator the Financial Reporting Council on the topic not due until the end of the year, no real decisions or deals should be struck until the guidance, issued in a consultative format, is absorbed and understood.

Bromell believes that the guidance from the FRC will not be too prescriptive, leaving options open for both auditors and their clients. However, this could cause its own problems.

Proportionality or cap?

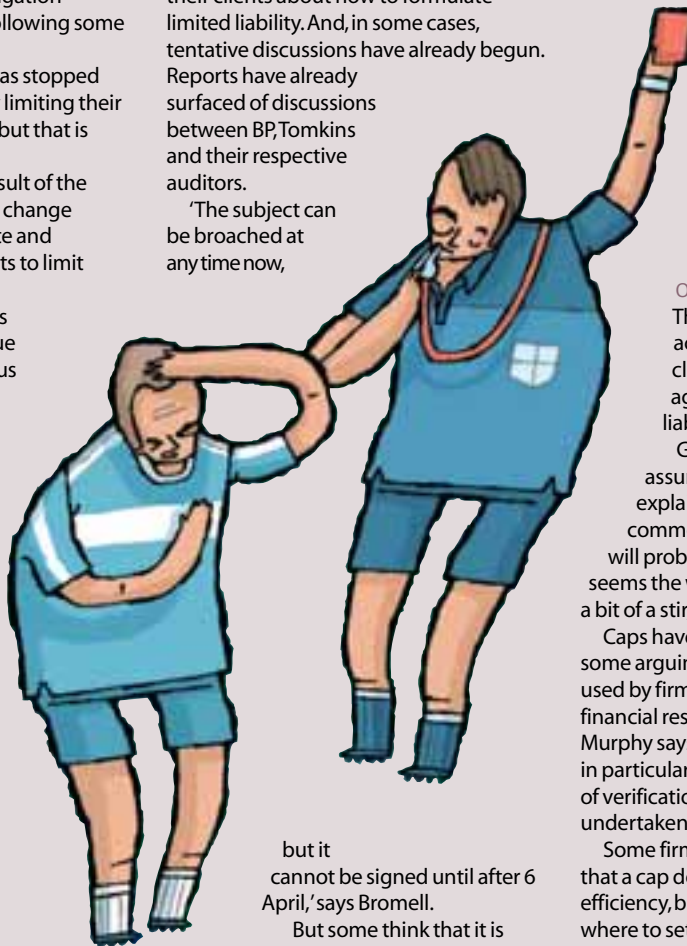
The key issue identified for the accounting profession, and its clients, to consider is whether to agree to a proportional limit on liability, or a monetary cap.

Giles Murphy, head of audit and assurance at Smith & Williamson, explains that caps are commonplace elsewhere, but audit will probably be a different matter. 'It seems the whole idea of caps has caused a bit of a stir,' says Murphy.

Caps have been heavily criticised, with some arguing that they would only be used by firms looking to abdicate their financial responsibility for a botched job. Murphy says that, for finance directors in particular, the audit is about the quality of verification, and how efficiently it is undertaken.

Some firms, says Murphy, would argue that a cap does not impact on quality or efficiency, but the next question would be where to set the limit. Would you choose an auditor because it offered the highest cap? How does that guarantee, or suggest, the level of quality of the audit?

Murphy thinks firms could only argue that a cap avoids the 'Armageddon' situation faced by Andersen, even though



but it cannot be signed until after 6 April,' says Bromell.

But some think that it is premature to have any meaningful negotiations at this time. Ernst & Young senior partner Gerald Russell warns against starting formal negotiations too early. He argues that, with guidance from financial

litigation did not kill the firm. It would also avoid the 'deep pocket situation', he argues, reducing the likelihood that other firms within an accounting network would be forced to cover the damages of another member firm.

Jane Howard, a partner at professional indemnity firm Reynolds Porter Chamberlain, believes most firms will look to a form of proportionality, as opposed to caps, when discussing plans with audit clients.

But strangely, the markets did not expect there to be a choice until recently. For the reasons above, and others, firms were not expected to be given a choice of limitation by cap. But late changes to legislation permitted the choice.

Signing the contract

Market forces could be key to the way contracts are formed, and in which format. Russell says that the market should not force auditors to win assignments by setting high caps or a high proportion of liability. Auditors that try to win clients on this basis would be 'unprofessional', in his opinion.

James Barbour, director of accounting and auditing at ICAS, says that FRC's guidelines should bring stability to the way in which agreements are structured. That way, both parties don't get into a position whereby agreement cannot be reached, the auditor quits on that basis and then the client cannot find another auditor to take up the work.

'If a business turns down a standard agreement, it wouldn't be easy to go to [other auditors] if the terms were quite standard,' adds Barbour. Each company and every audit is different, so he still expects agreements to require tailoring.

S&W's Murphy says businesses should also bear in mind that service providers tend to face more risk from other service lines, such as tax, and that could influence the level at which audit liability is set at.

Reputational risk is a bigger issue for auditors, and limited liability does not protect against that.

But businesses should expect some

haggling, Murphy adds, and we may even see some tenders change hands because of it.

The greatest priority for the business, however, is audit quality and maintaining a healthy relationship with its audit firm, which should be considered before ditching a trusted provider.

While there is not a 'wealth of knowledge' on market practice yet, Murphy wonders whether discussions will be any different to that on other services, despite audit's uniqueness.

Reynolds Porter Chamberlain's Howard agrees that guidelines issued by the watchdog will be critical, as both sides will have access to their recommendations, so she believes nothing concrete will be agreed between any two parties until they have been revealed.

Caps, Howard believes, could set off a backlash from clients, as it gives clients the 'whip hand'.

'Clients will be in a good position,' says Howard. 'Caps will be slow to come in'.

But, ominously, she adds that at least one mid-tier firm is putting together proposals for proportionality and cap agreements. 'They're dipping their toe in the water on that.'

Howard suggests the auditors will have some power, as she concedes there is the potential for auditors to drop a client if there is disagreement over liability proposals.

Crowd pleaser

One of the most profound issues that businesses, and their auditors, face is convincing stakeholders that the agreement struck is fair and reasonable. Shareholders will vote to agree on the deal as part of their AGM responsibilities. Reappointing auditors goes by without any fuss 999 times out of 1,000, but will shareholders be as benign on limited liability? They have become much more active around directors' remuneration.

Advisers suggest that engaging shareholders with the process as early as possible is vital to get them onside. 'If you're a public company you want to make sure [shareholders] will approve it.

One of the most profound issues businesses and their auditors face is convincing shareholders



Tactics

DO – begin discussions with your auditor on liability agreements

DON'T – sign any definitive agreements until guidelines have been issued.

Limited liability only comes into effect from 6 April 2008 anyway

ENGAGE – shareholders, who will vote on the agreement you have reached with your audit firm. So involve major stakeholders throughout the process to avoid an embarrassing AGM, and an auditor that reconsiders its position

PROPORTIONALITY – is expected to be the most popular form of liability limitation, but the law allows for caps, and this may suit you and your auditor better

AVOID – firms trying to win work by offering a high cap. It should set off alarm bells – focus on quality instead

WATCH – the market, see what competitors do, read *Accountancy Age* for the detail on deals struck

TAILOR – the deal to suit your company and its situation. Guidelines and norms are there to help but not to tie down companies. Proportionality, cap or even multiples of fees? You decide.

I would expect institutional investors to be soured out on this,' said Bromell.

'We're moving into a new area,' says Russell. 'Companies will have to second-guess. When you put things to individual shareholders as you do in an AGM they can do what they like, so business has to educate. Sensible companies will sound out shareholders but you can't cover all of them.'

Guidelines, when issued, will lead to accepted norms, says Russell, which should ease this part of the process.



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The time may come when changing your auditor becomes a necessity, writes Nicholas Neveling. We show you how to make the transition as painless as possible

New signing

It is a late winter morning in April 2006 when the board of beleaguered music company Sanctuary Group finally makes the decision to change auditors.

Over the last six months, the company has been through hell. Incumbent auditor Baker Tilly has qualified its latest set of annual accounts, saying the company understated losses by £15.6m in 2005.

The business has just raised £110m in rescue capital and takes the decision to call in KPMG and make a fresh start. The company takes enormous flak for its decision. It is accused of dumping its current auditor simply because the firm gave a negative audit opinion.

It takes weeks for the furore and negative headlines to subside. Changing auditors can be a traumatic experience.

Going through changes

Of course, not all auditor changes need to be, or indeed are, as dramatic as the Sanctuary Group example, but any finance director or company who thinks that changing an auditor is as simple as switching your electricity supplier is in for a rude shock.

Changing auditors is a complex and, if anecdotal evidence is to be believed, costly process; but if it is done correctly, the benefits can be significant; bringing cost savings, offering better value for money and producing an audit of higher quality and greater rigour.

Why change?

There are a number of reasons why firms should consider switching auditors. Serge Corel, the finance director of support services giant Mondial UK, describes what is perhaps the most important of these. 'After a certain period of time your relationship with your auditor can become a little bit too comfortable. If it were compulsory to change auditors, it would force you to put everything on the table and look at it with fresh pair of eyes,' Corel says.

'I think that when an auditor has worked with a company for a number of years it does not always give it the same attention that it could, because it is comfortable.'

Other, more practical reasons are when a business undergoes a rapid period of growth through acquisition and doubles or triples in size over a short period of time.

In such circumstances, it is highly likely that a firm has outgrown its current auditor and needs to look to a firm with more experience of auditing larger businesses.

Then there are questions of value for money. Are the services provided still at the standard as when the auditor was first appointed? Are the fees charged for audit still competitive with what other firms are offering?

Finance directors and audit committees need to work through all these questions. Audit committees should be asking these questions and

conducting a formal review of their auditor at least once a year. It is where the process for changing an auditor begins.

Starting off the tender

Once the decision has been taken to make a change, it is essential that companies manage the process to make sure the right firm is hired.



As companies, particularly larger ones, change auditors so seldom (once every 48 years if you are in the FTSE 100) there is no fixed formula for managing the process and there are different schools of thought on how to proceed.

Steve Maslin, head of external professional affairs at Grant Thornton, likes the idea of keeping the process focused and easy to manage. 'There are so many firms out there with all sorts of experience. A company needs to narrow its search to where it thinks it will find the expertise and experience it requires,' he says.

'Before a company makes any contact with firms it should draw up a shortlist of firms that will meet its needs. It needs to identify firms with the technical experience and right geographical spread for its purposes.'

Maslin suggests that a business should start tendering the audit only once a group of three or four such firms has been identified. 'I think it is better to have a small group of candidates rather than contacting every single top 15 firm when you know that some of them are not going to offer what is needed for the audit,' he says.

David Herbinet, head of public interest markets at Mazars, prefers to cast the net as wide as possible. 'I think it is best for a company to be open about the fact that it is planning to change auditors and I would advise advertising widely and inviting applications from all interested parties. From there you can shortlist the best candidates and then go through a more formal assessment before making your final choice,' Herbinet says.

Take a test drive

Herbinet also likes the idea of testing out

Quality assurance

Switching auditors has never been regarded as anything more than bringing in a fresh pair of eyes to look over the company books at the very most.

The focus on competition and choice in the audit market, however, has suddenly thrust auditor rotation into the forefront of the financial world's consciousness.

The practice is no longer regarded as merely good

house-keeping, but rather as a possible solution to concerns that the audit market at the top end, particularly in the FTSE 350, is too concentrated.

As part of the Financial Reporting Council's drive to enhance audit quality (see pages 2-3), several recommendations have been made by its market participants group (MPG) with respect to the appointment and re-appointment of auditors. This includes improving information flow from

and outgoing to an incoming auditor, using firms from more than one audit network and disclosing contractual obligations to appoint certain types of firm

The MPG did not go so far as to demand compulsory auditor rotation, but the measures outlined above are a clear attempt to make changing auditors easier and more fluid. From being an issue that nobody paid attention too, audit rotation is suddenly in fashion.

potential future auditors by offering them other work. 'I think a business can gain invaluable knowledge by offering potential auditors work in other areas, such as tax or due diligence. There is no better way to develop a practical feel for how you relate to a firm and how you work together. If you go into a tender with this kind of knowledge you are in a much better position to select the right auditor for your business,' Herbinet says.

Managing the transition

Once your new auditor has been chosen, the next step is the perhaps the most challenging. When experts discuss the cost of switching auditors, it is the transition they are referring to.

Like it or not, your outgoing auditor will have an understanding and insight

into your business that the new incumbent will take time to develop. This is perhaps the main reason why many businesses find it easier to stick with their current auditor, because even if the relationship is not as good as it could be they dread going through the turmoil of a transition.

Herbinet says that one way to ease the pain of an auditor transition is to make use of a joint audit. 'The handover is a big thing that can create additional cost and risk. Using a joint audit for a few months can smooth the out the transition and facilitate a transfer of expertise,' he says.

and staff – invaluable knowledge to have when making a decision.

4. REPEAT STEP ONE

When you have drawn up a shortlist you should ask the new firms tendering for the audit the exact same questions you asked of your outgoing auditor. Value for money, fees, audit quality.

5. MANAGE THE HANDOVER

Ensure a smooth transition by setting out a clear handover timetable. Avoid making a change during a busy time such as year-end or results day. One way to manage the transition is to have the two auditors working together over a transition period in a joint audit set-up.

Top tips for auditor transition

1. ASSESS YOUR OPTIONS

Does your auditor provide value for money? Are the fees charged competitive? Is the audit quality what you expect? Does your auditor still match your size and growth? These questions need to be asked annually by the audit committee. If the answers aren't satisfactory it is time for a change.

2. IDENTIFY POTENTIAL REPLACEMENTS

This can involve advertising widely in order to select from as big a pool as possible, or identifying a select group of firms that meet specific auditing requirements.

3. TAKE A TEST DRIVE

Hiring potential auditors for tax or due diligence work can provide you with an opportunity to see how you relate with a firm's culture

Does your auditor provide value for money? Are the fees charged competitive? Is the audit quality what you expect?

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CHARTERED ACCOUNTANTS AND BUSINESS ADVISERS

Playing low-ball

Are the Big Four deliberately keeping down prices to keep out rivals? asks Peter Williams

The Big Four say they welcome the idea of more audit choice for large companies. But do they mean what they say? After all, the concept of greater audit choice for big business implies that the top firms would lose audits, market share and profit.

In this debate, the subject of low-balling has always been the elephant in the corner: something that is really obvious, but which has never been properly discussed.

Priced out the market

The ultimate purpose of predatory pricing is to sell goods or services at artificially low prices with the intent of driving competitors out of the market, or to create a barrier to entry into the market for potential new competitors. The predatory pricer then has fewer competitors or even a monopoly, allowing it to raise prices above the level that the market would otherwise bear. Audit choice and low-balling are two sides of the same coin.

It is not in the interest of any of the major players to open up the question of predatory pricing. The Big Four audit firms don't want to discuss it, nor do finance directors. So the audit trail on low-balling goes cold. While some accept low-balling as an absolute fact of life, others deny that it ever happens.

Certainly, the documented evidence on low-balling is rare, but every few years there is a low-balling tale or accusation from someone who ought to know. And this keeps alive the idea that absence of evidence does not equate to evidence of absence.

The latest explosion came from Jeremy Newman, managing partner of BDO Stoy Hayward, who is leading a sustained

assault on the Big Four. A clearly exasperated Newman has put into the public domain the story of a due diligence job for which his firm quoted. Despite the fact that the maximum fee level BDO asked for was a third of the initial price of the company's auditors, the work eventually ended up being performed by the incumbent for around 10% more than BDO's top quote.

It is tempting to dismiss the tale as an example of a canny FD using a different supplier as a stick with which to beat the incumbent – and presumably favoured auditor – into providing the service at a more reasonable price. Or is it, as Newman suggests, predatory pricing designed to force out his firm from competing in certain segments of the marketplace?

Under attack

Significantly, Newman also claims that the Big Four firms are increasingly targeting BDO clients – and presumably the other mid-tier firms – by promising significantly reduced fees, which the incumbent is forced to at least match, or risk losing the work.

Even smaller firms feel the threat of low-balling.

These independents find their biggest clients – significant private companies, but not quoted entities – are regularly targeted by the Big Four.

One way in which the incidence of low-balling could decrease would be if clients made it clear that being the auditor gave a professional firm no advantage when it came to bidding and winning other work. The downside of that step is, why should FDs bother? It's convenient to work with professionals who know your business.

Jeremy Newman chose to release his tale about low-balling at a time when the Financial Reporting Council is consulting



on audit concentration.

Part of the recommendations of the Market Participants Group should have an impact on the possibility of low-balling. For instance, the recommendation that audit firms disclose the financial results of their work on statutory audits and directly related services on a comparable basis should ensure relevant information emerges over time about audit firms' current pricing policies.

The question at the heart of the debate on increasing choice in the audit market is how hard the Big Four firms are prepared to fight to hold on to their market share. All the evidence suggests the answer to that question is easy: very hard indeed. *This is an edited version of an article that first appeared in Financial Director magazine*

Every few years
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Top 50 fees

Firm	Rank	Audit/ accounting (£m)	change on 2006	Top 50 rank (change on 2006)	UK fee income (£m)	Audit fee as % of total income
PricewaterhouseCoopers	1	952.0	11	1 (1)	1980.0	48%
Ernst & Young	2	587.0	23	4 (4)	1790.0	33%
Deloitte	3	558.0	15	2 (2)	1454.0	38%
KPMG LLP	4	421.0		3 (3)	1130.0	37%
Grant Thornton	5	131.6		5 (5)	387.1	34%
BDO Stoy Hayward	6	103.0	13	6 (6)	330.0	31%
Baker Tilly	7	92.7	4	7 (7)	200.4	46%
PKF	8	54.1	12	9 (9)	152.6	35%
Mazars	9	48.3	24	13 (14)	130.4	37%
Moore Stephens	10	36.0	8	11 (11)	123.6	29%
HW Group	11	26.2	15.4	15 (15)	107.2	24%
Horwath Clark Whitehill	12	25.7	14.2	17 (18)	73.0	35%
Bentley Jennison	13	24.7	5	14 (16)	72.3	34%
Smith & Williamson	14	23.8	4	8 (8)	63.7	37%
UHY Hacker Young	15	20.0	9	18 (19)	54.0	37%
Kingston Smith	16	17.0	8.35	19 (20)	44.7	38%
Tenon Group	17	15.9	7.4	10 (10)	41.2	39%
Saffery Champness	18	14.0	10.9	16 (17)	39.7	35%
Menzies	19	10.3		20 (21)	34.0	30%
Chantrey Vellacott DFK	20	9.7	2	22 (22)	30.2	32%
CLB Littlejohn Frazer	21	9.3	3.89	28 (28)	24.4	38%
Lovewell Blake	22	7.1	2.9	33 (32)	23.8	30%
Price Bailey	23	7.0	0	42 (37)	22.2	32%
Rothman Pantall & Co	24	6.9	1	39 (45)	19.0	36%
Francis Clark	25	6.4	20.14	34 (34)	18.1	35%
Larking Gowen	26	6.3	3	40 (40)	17.8	35%
Buzzacott	27	6.2	-3.6	30 (31)	17.7	35%
Shipleys	28	6.0	5.3	45 (45)	17.1	35%
Hazlewoods	29	5.9	8	38 (39)	12.5	47%
Streets	30	5.2	2	46 (44)	15.0	35%
Bishop Fleming	31	5.0		48 (50)	15.0	33%
Duncan & Toplis	32	4.6	12.6	35 (38)	14.0	33%
Cooper Parry	33	4.5	7.4	31 (30)	13.7	33%
Berg Kaprow Lewis	34	4.2	16	41 (47)	13.6	31%
Vantis #	35	4.0		12 (13)	11.7	
MacIntyre Hudson #	36	4.0		21 (23)	11.7	
Johnston Carmichael #	37	3.9		24 (24)	11.5	
DTE Group	38	3.8	23	25 (29)	13.4	28%
Armstrong Watson #	39	3.8		26 (27)	11.2	
Wilkins Kennedy #	40	3.6		27 (26)	10.6	
Ford Campbell #	41	3.6		29 (25)	10.5	
haysmacintyre #	42	3.5		32 (33)	10.4	
Scott-Moncrieff #	43	3.4		37 (36)	10.1	
Target Chartered Accountants #	44	3.4		47 (49)	10.0	
Haslers	45	3.3	17.5	36 (42)	13.0	25%
Reeves and Neyland	46	3.3	2	43 (41)	12.6	26%
Barnes Roffe #	47	3.2		49 (51)	9.3	
Morley and Scott #	48	3.1		50 (52)	9.2	
Mercer & Hole	49	2.8	4.58	44 (46)	12.5	23%
Wenham Major	50	1.9	-	23 (43)	12.3	15%

where no audit income figure has been provided it has been estimated by taking the Top 50 average income to audit fee percentage of 34%



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