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Dear Nathalie

## **GREEN PAPER - AUDIT POLICY: LESSONS FROM A CRISIS**

Standard Life Investments Limited, a wholly owned subsidiary of Standard Life plc, is one of Europe's largest asset managers. We manage assets with a value of €177.5 billion as at 30 September 2010. A very significant proportion of these assets are invested in the securities of listed European companies.

In fulfilling our investment management responsibilities, we attach a great deal of importance to having reliable financial and non-financial information on which to base our investment decisions and to assist us in fulfilling our stewardship responsibilities. Accordingly, we are pleased that the European Commission has published its Green Paper and is keen to assume leadership at the international level, since many of the issues pertaining to audit policy need to be considered in a global context.

Our detailed responses to the questions set out in the Green Paper are to be found in the attachment to this letter. Whenever possible, we have sought to make practical suggestions to assist you in developing proposals to address the issues. Let me summarise below some of the more significant comments.

- We should like the scope of the work undertaken by the external auditors to extend to providing reasonable and balanced assurance on matters contained in a company's business review and similar narrative reports.
- We believe the audit report should be more useful and relevant than is currently the case. We suggest the Commission should develop proposals to promote a European framework for audit reports terminology that is less binary and more discerning than is currently the norm.
- We do not believe there should be any limitation in time with respect to the engagement of audit firms. We are concerned that any limitation may result in a lower quality of audit.
- The provision of non-audit services by external auditors should not be prohibited. In our view, it would not be in the best interests of either the company or its shareholders. However, there should be higher minimum standards of transparency regarding non-audit services.
- We believe the major audit firms and networks should be restructured with the objective of creating a market that delivers a more meaningful choice of substantial and credible audit firms who are capable of providing high quality audit and assurance services at a reasonable cost. To achieve this objective, the Commission should co-ordinate its efforts with its global counterparts.

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We recognise that many of the issues raised by the Commission in the Green Paper cannot be addressed through legislation at either European or member state levels. Therefore, when appropriate, we urge the Commission to consider carefully the other tools that are available to it to encourage and stimulate behaviours and outcomes that will result in an audit and assurance market that delivers outcomes that will not only enjoy unambiguous support from shareholders and stakeholders but also stand the test of time with a view to enabling sustainable economic prosperity throughout Europe.

Yours sincerely

Guy R Jubb  
*Investment Director, Head of Corporate Governance*  
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## European Commission

### Green Paper

#### Audit Policy: Lessons from the Crisis

#### Response from Standard Life Investments Limited (UK)

##### Introduction

***Q1. Do you have general remarks on the approach and purposes of this Green Paper?***

We welcome the approach and purposes of the Green Paper. We should like to emphasise that from our perspective it is important that audit policy is considered in conjunction with the other aspects of corporate governance which the Commission is currently addressing. Therefore, we particularly welcome the reference to the feedback relating to the Green Paper on Corporate Governance being considered when evaluating the responses to the present Green Paper. It is important that these and any relevant policy initiatives are effectively integrated and co-ordinated.

***Q2. Do you believe that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements?***

We believe there is a need to better articulate the societal role of the audit in order to ensure that there is mutual understanding. In our view, this role, whilst acknowledged in the generality, does not enjoy a generally accepted understanding. That said, we believe that the primary role of the audit with regard to the financial statements is to the company's shareholders and we should be concerned if this primary responsibility was diluted inappropriately. Furthermore, we should emphasise the need to ensure that the societal role does not, of itself, open the floodgates of potential litigation, which could be counter productive in terms of strengthening the audit environment in Europe.

***Q3. Do you believe that the general level of 'audit quality' could be further enhanced?***

From our perspective, 'audit quality' comprises two components. First, the quality of audit processes and professional standards, which we believe could be further enhanced. Second is the quality of the audit report, which, especially when taken together with the report of the audit committee, offers generous scope for enhancement - of this we are convinced. Our views and suggestions in this regard are set out elsewhere in this response.

A separate review of pan-European professional standards for auditors would enable a well-informed evaluation designed to identify areas for improvement. In the meantime, the development of high level European professional standard principles would be a useful step in the right direction.

## **Role of the Auditor**

***Q4. Do you believe that audit should provide comfort on the financial health of companies? Are audits fit for such purpose?***

Yes, we believe audit should provide such comfort. We favour the true and fair view in respect of audited financial statements. However, we have been very disappointed that auditors and boards of directors in the UK have been extremely reluctant to use the 'true and fair over-ride' when they feel that such an over-ride would yield a more useful and relevant description of the company's financial position than is the case by applying IFRS or other generally accepted accounting standards.

In respect of narrative reporting, such as the business review, we believe that as a minimum standard auditors should provide negative assurance that there is nothing in the business review that is materially inconsistent with their findings during the audit of the financial statements.

Furthermore, in order to make the audit report much more useful and relevant, we believe that auditors, under instruction from the audit committee, should, when appropriate, provide bespoke assurance regarding specified matters. For example, it would be helpful if the auditor of a shipbuilder could provide reasonable assurance that order book information, which would usually be found in the business review, provides a reasonable reflection of the state of the order book and has been compiled with due care and consideration. If such assurance and transparency were conveyed via the audit committee (rather than in the auditor's report) to shareholders, we would be quite content.

Finally, we should like to see a more enlightened approach to auditors including 'matters of emphasis' in their audit reports. Currently, such 'matters of emphasis' are generally seen as contentious and are rarely provided. Rather, 'matters of emphasis' should be seen as an opportunity for auditors to assist shareholders and others in identifying those aspects of the audited financial statements that deserve special attention or consideration. For example, because of the significant uncertainties inherent in certain valuations, or because of a significant concentration of counterparty risk. This will help institutional investors in fulfilling their stewardship responsibilities. For the avoidance of doubt, we are not looking for every audit report to have a 'matter of emphasis' - rather, that they should be viewed as a constructive reporting tool and thereby become more prevalent than is currently the case.

***Q5. To bridge the expectation gap in order to clarify the role of audits, should the audit methodology employed be better explained to users?***

The expectation gap will never be bridged but there is undoubtedly scope to narrow it.

There is a generic need to improve the understanding of investment professionals about the role of audits, not least its limitations. We suggest that

more emphasis should be given to the role and limitations of audit in the training programmes for investment professionals.

In relation to a specific company, it may be helpful to have greater clarity regarding the audit methodology employed. That said, it is important that shareholders and investors should not micro-manage the audit process. Therefore, rather than 'audit methodology', we should prefer to see greater and meaningful transparency about the audit plan for the relevant financial period. This could cover identification of those aspects of audit which deserved particular attention in the planning process and how - in layman terms - they were addressed. By lifting the lid on this, shareholders would have a much better appreciation of the audit process. Thereby, the quality of engagement between institutional investors and audit committees should improve.

Whilst it may be appropriate to include this information in the audit committee report, the more detailed disclosures could be set out in a secure section of the company's website that is signed off by both the audit committee and the auditors to validate the information is 'fairly presented'. Such a secure section could also be used for other additional disclosures relating to the audit process.

***Q6. Should 'professional scepticism' be reinforced? How could this be achieved?***

Yes. We concur with views expressed by others that 'professional scepticism' was not as strong as it should have been in the period before the crisis. We recognise that such scepticism should be pitched at a sensible level. It is important that it is applied robustly but judiciously in a manner that strikes the right professional balance.

'Professional scepticism' should be reinforced both at the audit firm and the company specific levels.

At the audit firm level, this can be achieved by a stronger and more visible 'tone from the top'. The adoption of stronger audit firm governance arrangements along the lines of the Audit Firm Governance Code, which was published by the UK's Financial Reporting Council earlier this year, should go a long way to help reinforce this aspect of behaviour. The non-executives involved in the audit firms' governance structures should have a responsibility to satisfy themselves that the 'tone from the top' is effectively articulated and communicated in a manner that it does not go unnoticed by the professionals within the firm. It is relevant to note that this professional behaviour applies to all members on the audit team - not just the engagement partner.

Also, those responsible with regulating audit firms should focus consistently on 'professional scepticism' when undertaking their inspection reviews. Whilst it is unrealistic to expect such scepticism to be capable of measurement, an experienced audit inspector should be able to form a reasonable judgement as to whether an appropriate degree of 'professional scepticism' is being brought to bear.

At the company level, the audit committee has a role to satisfy itself that an appropriate degree of ‘professional scepticism’ in the audit of the company’s financial statements. To help audit committees have greater confidence in making this assessment and in fulfilling their other responsibilities, they should be expected to make greater use of the services of independent advisors - possibly other audit firms - than has hitherto been the case. It is notable that remuneration committees of major European companies have access to independent advice as a matter of course and without controversy. This is not the case with audit committees. Indeed, we believe that they often look to the auditors themselves for ‘independent advice’. This misses the point, since it is not independent of the audit process and can unintentionally reinforce unsound judgements, with unfortunate and unintended consequences, especially when the level of ‘professional scepticism’ is not sufficient.

Finally, ‘professional scepticism’ would be usefully reinforced if there were stronger governance arrangements when there is a change of auditors, which is an event that should be subject to robust scrutiny by shareholders, especially when the change is unexpected. There may be a natural tendency to replace auditors who are deemed by management - and possibly by the audit committee - as being ‘too difficult’, when in reality they are exercising that degree of ‘professional scepticism’ that is appropriate to the situation concerned. Currently, there is little transparency and no shareholder engagement when an audit firm is replaced. We recommend the Commission examines this area in more detail with a view to making improvements.

***Q7. Should the negative perception attached to qualifications in audit reports be reconsidered? If so how?***

Whilst it is generally correct that qualifications in audit reports should be seen negatively, it is very important that there is a better and more enlightened perception of the nature and significance of the terminology used in audit reports such as ‘matters of emphasis’ and the ‘true and fair override’ which have been referred to earlier in this response. Likewise with ‘material uncertainty’. However, when an auditor believes that the financial statements do not present a ‘true and fair view’ then it is right and proper that there should be a negative perception.

To address the situation, the Commission should develop proposals to promote a European framework of audit report terminology that is less binary and more discerning than tends to be the case currently.

***Q8. What additional information should be provided to external stakeholders and how?***

We believe that this should be determined on a company by company basis with the requirement that the boards of listed companies should provide transparency to evidence that:

- it has considered whether additional information should be provided to external stakeholders in respect of audit and assurance matters;
- how it has reached its decision, eg after consulting relevant stakeholders' and
- the outcome of its consideration.

It is important that such disclosures should not be boilerplate in nature and the Commission should take steps to prevent this. For a board to conclude that no additional information should be provided would be perfectly acceptable - what is important is that shareholders are given transparent assurance that it has given the matter due consideration.

Insofar as it relates to shareholders, we believe that audit committees should give careful consideration to what additional audit assurance their shareholders may find useful. For example, the shareholders in a support services company may value added audit assurance regarding the reliability of sales cut-off at the year end. Whether that assurance is provided by the audit committee or the external auditors would be a matter of choice having regard to the circumstances of the company.

Importantly, we believe there is scope for enhancing usefully the transparency of the audit committee. Additional information could be provided by the audit committee to lend confidence to both the overall internal and external audit processes, and the corporate report taken as a whole. Currently, there is great variation between companies. We believe that minimum standards of audit committee reporting need to be established. In this respect, we commend to you as a starting point the Guidelines for Enhanced Disclosure to assist boards, audit committees and investors, which can be found at [www.enhanceddisclosure.org](http://www.enhanceddisclosure.org).

The enhanced audit committee report should be reviewed by the external auditors, who should refer specifically to this in their audit report. This will reinforce the reliance that can be placed by shareholders and others on the audit committee report.

In respect of additional information for other external stakeholders it is difficult to be prescriptive given their diverse nature. That said, there are stakeholders that are common to most entities, such as employees, suppliers and customers. We suggest that the Commission undertake further research into reporting to other stakeholders.

Notwithstanding the above, we are concerned about information overload: it is sometimes difficult for readers of corporate reports to 'see the wood from the trees'<sup>1</sup>. Whilst this is not an issue of concern currently with audit committee and external auditor reports it is nevertheless essential that the Commission has regard to the communication effectiveness of the additional disclosures and also their cost, which must never be overlooked.

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<sup>1</sup> Institute of Chartered Accountants of Scotland: 'Making Corporate Reports Readable'.

***Q9. Is there adequate and regular dialogue between external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?***

As shareholders, it is currently impossible for us to discern with reliability whether or not the dialogue is 'adequate and regular'. That said, we should emphasise that nothing has come to our attention to suggest that such dialogue is not achieved in the generality. However, it would be appropriate that there is mutual recognition between the Audit Committee and the auditors that the dialogue has been not only 'adequate and regular' but also 'sufficient and appropriate'. To require disclosure of this by the Audit Committee and/or the external auditors so far as it relates to them, will, of itself, help to ensure achievement of the desired dialogue.

***Q10. Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?***

Please refer to our response to Q8. In summary, we believe that any such role should be determined on a company by company basis in a manner that is decided on an appropriately informed basis and has due regard to cost effectiveness.

***Q11. Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between year end and the date of the audit opinion be reduced?***

In general, we do not have a problem with the regularity of communication by the auditor to shareholders. However, consistent with the views expressed previously, when a company's circumstances dictate that there should be more regular reporting by auditors to shareholders then companies and their audit committees should be willing to take a more enlightened approach to enabling more regular communication by auditors than is currently the norm.

In general, we do not have a problem with the time gap between the year end and the date of the audit opinion. Hence, we do not regard this as a priority for the Commission at this stage.

***Q12. What other measures could be envisaged to enhance the value of audits?***

- (a) Improved communication between audit committees and shareholders. In our experience, there is negligible dialogue between shareholders and audit committees. This is a notable omission within the framework for effective corporate governance. Such a dialogue, conducted under conditions that do not give rise to market abuse, should be mutually beneficial and help to empower the Audit Committee to fulfil its responsibilities. The Commission should give encouragement to such dialogue taking place on a systematic basis.
- (b) Working with national regulators and other relevant industry bodies, the Commission should take steps to improve the training on audit matters by



- (c) Currently, there is no provision for auditors of public companies to speak to shareholders when they have matters of concern. In our opinion, this is an important deficiency in the European framework for corporate governance and needs to be addressed in a manner that is regulatory compliant. It follows that the Commission should examine how ‘safe harbour provisions’ can be established when the external auditor of a listed company wishes to communicate with the company’s shareholders. This is a sensitive and complex area, especially when having regard to the legal and other provisions that apply in different member states. However, we believe it is important that this matter should not be put into the ‘too difficult’ category.
- (d) We believe that there can be significant differences in approach to the relationship between external auditors and shareholders of public and private companies. We recommend that the Commission undertake a comparative study to ascertain if there are differences and, if so, what lessons can be learned for either or both constituencies in respect of improving the auditor shareholder relationship for European companies.

### **International Standards on Auditing (ISAs)**

#### ***Q13. What are your views on the introduction of ISAs otherwise in the EU?***

In general, we support ISAs since, taken as a whole and accepting that there is always room for improvement, they provide a sound framework of auditing standards. Hence, subject to the views of the Commission in respect of the needs of SMEs and SMPs, we welcome their introduction and utilisation in the EU. In this regard, it is important to emphasise that we believe it is important that ISAs should be introduced as a complete package across Europe, without any selective ‘carve-outs’.

#### ***Q14. Should ISAs be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing with the endorsement of International Financial Reporting Standards (IFRS)? Alternatively, and given the widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?***

As noted above, we believe that the endorsement of ISAs should be as a whole rather than on a selective basis. Also, we should be concerned if individual member states were to seek ‘carve-out’ arrangements without good cause.

Whilst we would not be averse to ISAs being made legally binding throughout the EU in order to achieve a consistent approach across member states, our natural disposition is to prefer a non-binding approach. We would suggest

that such a non-binding approach is subject to a form of review and confirmation at, say, triennial intervals in order that the Commission and relevant stakeholders can reasonably satisfy themselves that it is proving to be ‘fit for purpose’.

***Q15. Should ISAs be further adapted to meet the needs of SMEs and SMPs?***

We do not have any significant investment interest in SMEs and SMPs and, therefore, have no substantive comment to render.

**Governance & Independence of Audit Firms**

***Q16. Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?***

Whilst we accept that there is an inherent conflict, we would emphasise that in most, if not all, listed European companies there is a requirement for an independent audit committee, which should provide a check and balance to prevent the conflict being abused. Furthermore, and importantly, in many member states the appointment/re-election of auditors is subject to shareholder approval, which provides a further line of defence. Hence, we would oppose ‘a scenario where the audit role is one of statutory inspection where in the appointment, remuneration and duration of the engagement would be the responsibility of a third party, perhaps a regulator, rather than the company itself’ as referenced in the Green Paper. In our opinion, such a scenario would seriously undermine the relationship between auditors and shareholders.

Rather, we would like to see the Commission take steps to ensure that the appointment or re-election of the auditor is always subject to annual approval by the shareholders and that in the relevant AGM notice there are minimum standards of transparency regarding the relationship between the company and its auditors. This will ensure shareholders make appropriately informed voting decisions. Such disclosures might, for example, include the amounts paid to the auditor in respect of audit and non-audit fees for, say, the last three years, the length of tenure of the audit firm, the date the audit was last put out to tender, and the company specific reasons why the Board is recommending election/re-appointment.

Furthermore, when there is a change of auditor we believe that there should be full and timely transparency to shareholders including, inter alia, the professional views of the out-going auditor, in order that shareholders are assured, or otherwise, that there are no relevant matters that they should take into account when assessing the change and voting on the appointment of the new auditor. In our experience, the lack of transparency regarding the context of a change in auditor and the views of the out-going auditor is a major weakness in European corporate governance. Too often, companies and the out-going auditor cite reasons of confidentiality as justification for not disclosing the reasons for the change such that there is no meaningful

transparency, which is most unsatisfactory. This is a governance-critical change on which there should be effective accountability.

***Q17. Would the appointment of a third party be justified in certain cases?***

We do not believe that the appointment by a third party could be justified in certain cases.

***Q18. Should the continuous engagement of audit firm be limited in time? If so, what should be the maximum length of an audit firm engagement?***

We do not believe there should be any limitation in time regarding the engagement of audit firms. We attach due importance to the embedded knowledge of incumbent auditors and for this reason we should be concerned that any limitation may result in a lower quality of audit, which could be compounded by the behavioural factors that could come into play when an auditor knows that his appointment will not be renewed. Furthermore, it is generally accepted that there is a higher risk of audit failure in the early years of appointment.

However, we should welcome greater transparency from companies regarding their policy for tendering. This is discussed in detail in our response to Q29.

In addition, we believe the Commission should encourage the independent audit regulators in member states (or the possible European audit regulator - see later) to exercise greater oversight of the audit when the auditor has been the incumbent auditor for, say, 20 years or more in order to provide further and appropriate reassurance that the length of tenure is not compromising audit quality. If the relevant independent audit regulator is not satisfied in this regard then it should be empowered to enforce relevant sanctions in a transparent way that would highlight any shortcomings that came to its attention.

***Q19. Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?***

The provision of non-audit services should not be prohibited. In our view, it would not be in the best interests of either the company or its shareholders. However, we do encourage the Commission to require higher minimum standards of transparency regarding the nature and quantum of non-audit services, as well as the controls, if any, that are in place in respect of the provision of such services.

***Q20. Should the maximum level of fees an audit firm can receive from a single client be regulated?***

We do not believe there should be a maximum level in respect of such fees. However, we would support provisions that require the auditors of listed companies to submit transparency reports to them that require disclosure when the revenue from a single client represents more than, say, 10% of the firm's total revenues. The clients can then assess whether or not the situation is acceptable. Furthermore, in the event that a client exceeds that threshold then this should be referenced in the explanatory notes accompanying the AGM notice pertaining to the appointment or re-appointment of the audit firm concerned. For the avoidance of doubt, 'a client' should be defined on a consolidated basis as opposed to just individual holding company or subsidiary.

***Q21. Should new rules be introduced regarding the transparency of the financial statements of audit firms?***

Yes. It is important that companies and their shareholders are confident that the financial position of their auditors is sound. In the event that the financial position of the auditors was not sound, there is a risk that in order to save costs they would 'cut corners' during the course of an audit and/or compromise their professional judgement - in both instances with adverse consequences for audit quality.

***Q22. What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?***

We commend the approach outlined in the UK's Audit Firm Governance Code. Whilst this would clearly need to be adapted to the circumstances of individual member states, we believe the principles set out in the Code should be capable of application on a Pan-European basis. Furthermore, we encourage the Commission to take steps with its global counterparts to oversee the application of these principles to the major global auditing networks.

***Q23. Should alternative structures be explored to allow audit firms to raise capital from external sources?***

Yes. We believe that such structures may help to facilitate greater choice in the audit market. We recognise that there are inherent issues relating to independence and professionalism but we believe that these can be addressed satisfactorily. We refer you to our letter of 12 March 2009 responding to the Commission's previous consultation on this matter, which is enclosed with this letter for ease of reference. Our views have not changed fundamentally since then.

***Q24. Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?***

We agree the suggestions. We are surprised that the suggested arrangements are not already in place.

## Supervision

***Q25. Which measures should be envisaged to improve further the integration and cooperation of audit firms in provision at EU level?***

We support the view that the supervision of audit firms in Europe must be performed ‘on a more integrated basis’. Improved coordination and cooperation between national audit oversight bodies along the lines outlined in the Green Paper could be a useful step in the right direction. However, the envisaged Committee should also have powers to ensure that enforcement measures are coordinated effectively across relevant member states.

***Q26. How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved?***

We support the Commission’s view that there is a need to reinforce the dialogue between regulators and auditors. Furthermore, that this dialogue should be a two-way process so that supervisors also alert auditors regarding particular areas of concern. Whilst the Commission might be right to consider whether such communication should be mandatory to all large or listed companies, we would counsel caution in this respect insofar as we believe that such an approach could be counter-productive given the scale of such communications and the potential for ‘boilerplate’ disclosures, as well as the sheer cost of the exercise. Rather, such communication should focus on those entities that are genuinely ‘too big to fail’ or otherwise are giving rise to particular concern. It might also be appropriate to identify a category of company where it is felt that regulators would benefit from negative assurance from the auditors that there is no matter that they wish to bring to the regulator’s attention.

It has been a matter of surprise that regulators have not sought to enter into a systematic dialogue with long-term institutional investors regarding areas of concerns. Such investors may be able to bring a useful perspective to assist regulators in fulfilling their responsibilities - for example in respect of the governance and management of the companies concerned. It is recognised that, unlike the dialogue between supervisors and auditors, this would be more of a one-way process, given that there are inherent limitations as to the information which regulators can share with institutional investors. That said, the experience of the recent crisis suggest that it would be wise to establish ‘safe harbour’ channels of communications with institutional investors, which would enable a dialogue to take place on a regulatory compliant basis in exceptional circumstances - for example when there is an emerging need for additional finance to be provided by institutional investors.

## Concentration and Market Structure

***Q27. Could the current configuration of the audit market present a systemic risk?***

In our letter of 12 March 2009 to the Commission we stated that, “we have for several years expressed consistent concerns about the status quo in respect of the audit market”. Little has changed in the audit market since then. Therefore, we continue to “urge the Commission to move with a greater sense of urgency than hitherto and provide bold leadership in order to make serious headway towards a sustainable audit market, which would be consistent with maintaining financial stability and strengthening market confidence.” The current configuration of the audit market presents a systemic risk which has the potential to undermine financial stability and the confidence of capital markets.

***Q28. Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non-systematic firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firm to participate more substantially in the segment of larger audits?***

Such a consortium approach would not be desirable. In our opinion, rather than acting “as a catalyst for dynamising the audit market” it will tend to reinforce the demarcation between the “Big Four” audit networks and their smaller counterparts. Hence, we do not support the consortium proposal.

***Q29. From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?***

***Q30. How should the ‘Big Four’ bias be addressed?***

***Q31. Do you agree that contingency plans, including living rules, could be key in addressing systemic risks and the risks of audit firm failure?***

***Q32. Is the broader rationale for consolidation of large audit firms over the past two decades (ie global offer, synergies) still valid. In what circumstances, could a reversal be envisaged?***

We firmly believe that the structure of audit markets needs to be enhanced. In our letter of 12 March 2009 to the Commission we stated that “the structural situation and the inherent risks thereof remain unacceptable”. As noted in that letter, we believe that market forces “have failed to deliver a meaningful solution”, and therefore we continue to encourage the Commission to “develop and progress solutions with alacrity, in such a way that confidence in the audit market is strengthened”. We believe that the solutions developed by the Commission should (a) focus on strengthening the transparency and shareholder engagement in respect of the rotation and tendering arrangements that subsist at individual companies and (b) articulate its clear intention to intervene to break-up the major auditing firms into smaller components, if market forces fail to find a satisfactory solution.

The objective of restructuring the audit firms and their global networks should be to create a market of global and national audit service providers that delivers a meaningful choice of substantial and credible audit service providers who are capable of providing high quality global and national audit and assurance services at a reasonable cost. One should not be prescriptive as to how many firms and networks there should be but eight or more feels like a sensible benchmark to use. To achieve this objective the Commission should co-ordinate its efforts with its global counterparts.

We do not support mandatory rotation after a fixed period. We believe this is an artificial rule-based approach which could lead to a reduction in audit quality in view of the inherent risks associated with a change in auditor, especially when such change is mandated. For example, we should be concerned that in a mandatory rotation environment audit firms would “duck” difficult audit decisions in the knowledge that they can be “rolled over” to the next auditor, with the result that capital markets would be relying on information that is subject to a systemic reduction in audit quality.

However, we should welcome greater transparency by companies and their audit committees regarding their policy approach towards audit tendering. Therefore, we believe that the Commission should recommend to member states that their legislative and/or corporate governance codes provide that companies disclose their policy for tendering. In the event that the Commission decides to propose a fixed period for rotation and tendering, we would hope that any mandatory interval between tenders and/or rotation would be at least ten years. The costs - direct and indirect - of tendering and rotation should not be underestimated.

In our experience, investors are not involved in the auditor selection process. We believe audit committees and/or the board should make themselves available to explain to major investors any changes of auditor. This should provide a useful ‘check and balance’ in the process and assist in ensuring a mutual understanding of the circumstances and the process outcome.

On the level of the structural arrangements of the audit market in Europe - and, indeed, globally - we remain of the view that the Commission needs to provide clear and bold leadership to make serious headway towards a sustainable audit market structure along the lines of the objective stated above. We believe that the Commission needs to grasp this nettle with a sense of determined resolve. There had been plenty time for discussion; the time for generating and maintaining a momentum for change has come and is arguably overdue.

To achieve a sustainable audit market in Europe, we commend to the Commission an approach whereby it conveys strong, constructive, and unambiguous encouragement to the larger audit firms to restructure their operations - possibly by demerger or other strategic combinations. This should be combined with an undertaking by the Commission to conduct a further review of the audit market structure in, say, 2-3 years time with terms of reference that will require it to mandate structural changes to the firms if it is not satisfied that the structural issues have been addressed. This approach

of an “iron fist in a velvet glove” would rightly give the audit firms the opportunity to shape their own destiny within a reasonable time period whilst at the same time provide clarity of intent on the part of the Commission to intervene if the major audit firms fail to respond constructively to its initiative.

Irrespective of how the structural issues are resolved, we agree that it seems sensible for major audit firms to develop contingency plans, including living wills, to help address the risks of firm failure. We should emphasise that we do not regard such “living wills” as being of themselves a solution to the systemic risks and structural weaknesses that have been previously referred to.

It will be inferred from the foregoing that we do not regard the broader rationale for consolidation of large audit firms over the past two decades as being still valid.

### **Creation of a European Market**

*Q33. What in your view is the best manner to enhance cross-border mobility of audit professionals?*

*Q34. Do you agree with “maximum harmonisation” combined with a single European passport for auditors and audit firms? Do you believe this should apply for smaller firms?*

We note the representation in the Green Paper that “many barriers to integration of the European audit market remain and that cross-border mobility of audit professionals is still low”. We defer to its judgement in this regard but would observe that we have not seen this as a problem. Hence, if the Commission intends to address this, we would encourage it to treat it as a relatively low priority.

We concur with the view in the Green Paper that regulatory layers at various levels “have led to a degree of complexity that creates barriers”. Hence, we would support a move towards a single European market for the provision of audit services that could be based on enhanced harmonisation and a European passport for auditors and audit firms. We have no practical suggestions to offer in this regard but we believe it deserves further consideration.

### **Simplification: small and medium sized enterprises and practitioners**

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

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



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

As major and global investors, we have little interaction and involvement with SMEs directly. Therefore, we shall not respond in detail to these questions other than observing that, having regard to the impact of SMEs and the limited level of systemic risk to markets that they create, we would favour a lower level of service for the financial statements of SMEs instead of statutory audit, provided that the SMEs themselves are of like mind.

### **International Co-operation**

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

In our view, effective oversight of global audit players is critical to achieving the desired improvements with a view to minimising systemic risks, enhancing audit quality around the globe in a manner that is consistent with the best interests of European shareholders, capital markets and the interests of the public.

We believe the Commission should make a clear commitment and secure political support at the highest possible level to enhancing the quality of global audit oversight. We envisage that this will probably involve championing the commitment at G8 and G20 levels as well as securing the support of relevant bodies entrusted with financial stability responsibilities.

At the level of national regulators, we have been pleased with the progress in recent years in establishing the International Federation of Independent Audit Regulators (IFIAR) to enable a meaningful dialogue and shared understanding on many of the issues pertaining to the oversight of global audit firms and networks. However, it is frustrating that IFIAR of itself has been unable to enact co-ordinated regulatory measures and to facilitate co-operation on regulatory enforcement measures. We encourage the Commission to explore with IFIAR how it can achieve a modus operandi that enables international co-operation that delivers confidence in its ability to enhance the quality of oversight of global audit firms and networks. In this regard, we would emphasise the importance of involving regulators and audit firms and networks in Asia and elsewhere to ensure that the initiative is genuinely global and not just transatlantic.

On a functional level, IFIAR has started to facilitate tri-lateral engagement between international independent audit regulators, major global auditing networks and major global investors. Also, we and others participate in the Global Auditor Investor Dialogue. Both these initiatives provide a useful yet informal mechanism for enhancing audit quality. The Commission should not only lend encouragement to them but also consider whether they provide a means for the Commission to interact informally with relevant parties in a

manner that is consistent with the objective of maintaining high quality audits within Europe, as well as around the globe.

2 December 2010

12 March 2009

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Dear Sirs

## **CONSULTATION ON CONTROL STRUCTURES IN AUDIT FIRMS AND THEIR CONSEQUENCE ON THE AUDIT MARKET**

Standard Life Investments, which is an indirectly wholly owned subsidiary of Standard Life plc, is a major global investor with assets under management of £123.8 billion as at 31 December 2008. A significant proportion of these assets are invested in the securities of European companies that are subject to an annual audit. Therefore, we attach considerable importance to maintaining a sustainable audit market that delivers high quality audits and is otherwise 'fit for purpose'. Accordingly, we are grateful to you for consulting on the controls structures in audit firms and their consequences on the audit market since we believe these aspects have the potential to improve not only the degree of auditor choice available to companies but also, thereby, to improve the prospects for market and financial stability.

To set the scene, we have for several years expressed consistent concerns about the status quo in respect of the audit market. Little has changed in the audit market but there is increased likelihood of significant litigation against auditors in the wake of the current crisis. Therefore, we urge the Commission to move with a greater sense of urgency than hitherto and to provide bold leadership in order to make serious headway towards a sustainable audit market, which would be consistent with maintaining financial stability and strengthening market confidence. It is relevant to note that in the UK statutory provisions have been introduced to enable auditors to limit their liability, subject to shareholder approval, with a view to, inter alia, improving competition and choice in the audit market. Thus far the provisions have been rarely used and have had no impact whatsoever on audit market choice.

Our responses to the questions posed in the Working Paper are set out below.

**Q1.** *Do you see a need for opening up the market for the audit of international companies in order to have more European-wide audit service providers compared to the existing situation? Do we need a more integrated audit market? If yes, why?*

Yes, on both counts. In our opinion, the current situation is not sustainable. Some commentators suggest that the presence of the 'plus 2' auditing networks provides adequate competition but, in our experience of speaking to issuers, although one or other of the 'plus 2' networks are included in the tendering process, they rarely provide serious competition to the

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Big 4 networks. We should emphasise that, from our standpoint, based on discussions with senior members of the 'plus 2' networks, they do appear to have the capability to service successfully international clients but regrettably perceptions and reputations tend to work against them.

As noted in the Working Paper, there is concentration in certain sectors, most noticeably the financial services sector in the UK. These concentrations are fundamentally unwelcome, and provide potentially for systematic risk.

The concerns have a global dimension. Europe is well-positioned to take a constructive lead in addressing them. Ideally, it would be useful if the EC worked closely with the SEC to develop a joint European/US solution.

*Q2. Do you believe that the current number and structures of the audit firms' networks are sufficient?*

No. The current number of audit firms' networks is arguably satisfactory in form but the perceived substance of the 'plus 2' auditing networks and of those on the next level means that in practice there is insufficient choice for the larger global companies.

We don't know enough about the structures of the audit firms to comment about them but we are disappointed that the smaller networks do not appear to have taken a more aggressive approach to developing their franchises (without impairing audit quality). Perhaps they need express encouragement and, possibly, an inducement from the Commission to make this happen. We are not convinced that market forces of themselves will deliver a timely solution.

We note that in the 1970s and early 1980s, the market was characterised as the 'Big 8 plus 2' auditors. To our mind, this was a genuinely competitive market environment. Perhaps the Commission should be more explicit than it has hitherto been regarding what would be the desired outcome in terms of what would constitute a competitive audit market.

*Q3. Is access to financial capital a key factor to accelerate further integration of audit firms and emergence of new players? Do you share the view that allowing for competing models will create the opportunity for more investments resulting in more global players? Are other models conceivable?*

*Q4. Would models other than the current one negatively affect auditors' independence? Is there a need for additional safeguards at European level to protect independence? If so, what safeguards should be strengthened?*

We believe that access to capital - or rather lack of it - is a perceived inhibitor to the emergence of new significant players capable of providing a credible global audit service. Also, a natural desire to retain a partnership ethos amongst the firm's partners is perceived as an inhibitor in this context. Hence, removing structural barriers to enable access to capital is a pre-requisite to achieving progress but it will make little difference unless it is done in tandem with the development of models that are compatible with preserving and protecting - or even enhancing - the partnership ethos.

We suggest that models that would hinder rather than help progress would be those that would provide the possibility of too great a concentration of voting power with any one investor. Hence, we strongly commend the development of models that restrict investment by any one investors (and related parties) to not more than, say, 10% of the voting rights.

It is probably best that the Commission is not prescriptive in terms of defining the different types of capital but it might be useful for it to include in any future pronouncement an illustrative list of possible types of capital that can be used in order to ensure that those firms considering

capital raising do not feel inappropriately constrained and are, by implication, encouraged to tailor the capital instruments and capital structure to their particular requirements.

With regard to safeguards, the Commission should consider whether the processes of the professional licensing and oversight bodies in Member States need to be strengthened in order to ensure that there is an effective safe harbour if one of their professional members who is a partner in the firm and feels that his or her professional independence is under threat as a consequence, in whole or in part, of ownership and funding arrangements. It is very important that such professionals can raise these concerns with their professional bodies in order that the concerns can be evaluated, escalated and addressed in an appropriate manner.

*Q5. Should the Commission examine other catalysts accelerating access to the international audit market? If so, which one and why?*

Yes. Time is not on the Commission's side. There is a strong public interest, as we see it, in facing up to the facts and making serious and meaningful headway to address the status quo. One catalyst is to improve the substance of the explanation provided by a board when recommending the re-appointment of the auditor. Currently, most explanations that we see are boilerplate in nature. Also, the Commission should encourage boards and/or their audit committees to disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and of the key conclusions arising there from. This, of itself, will help to inject some catalytic grit into the process.

Also, the Commission should reflect whether, on balance, it is appropriate for Member States to offer fiscal or other financial inducements designed to increase the speed with which change occurs. For example, it might be in the public interest to offer tax breaks or tax deferment to partners in firms that have outside capital over a certain threshold proportionate level.

To help induce investors, the Commission may wish to explore with leading European stock markets whether a specially regulated market - possibly over the counter - for auditor capital and shares could be developed in order to provide liquidity, on the one hand, but ensure the integrity and standing of the beneficial owner, on the other hand.

Finally, the Commission may wish to consider whether it would be beneficial to articulate a negative incentive whereby it would make clear its intention to intervene to break-up the existing firms into smaller components, if market forces fail to find a satisfactory solution.

*Q6. Are current partnership forms of ownership indispensable in order to recruit, retain and further develop human capital? Could alternative structures under revised control rules allow audit firms to retain human capital and preserve audit quality?*

*Q7. Is human capital a factor more important than financial capital to expand internationally? Do you see in the current regulation for the audit profession any obstacles related to human capital preventing further integration of audit firms?*

In our view, partnership structures are dispensable but the partnership ethos is less so. We recognise and respect the professional benefits that can accrue to all concerned from maintaining a partnership ethos amongst Europe's leading audit firms.

As investors, it is difficult for us to judge if human capital is more important than financial capital to expand internationally. However, we would note that the two types of capital are not mutually exclusive and can be complimentary catalysts to making progress.

### Conclusion

Choice and ownership in the audit firm market has been debated for over a decade. The structural situation and the inherent risks thereof remain unacceptable. Market forces have failed to deliver a meaningful solution. Therefore, we should like the Commission to develop and progress solutions with alacrity, in such a way that confidence in the audit market is strengthened.

Bearing in mind the strong, albeit sometimes latent, public interest in this matter, we suggest the Commission has a responsibility to provide bold leadership to break the global gridlock and to prepare the ground for a more competitive and less concentrated audit market, recognising that some financial inducements may be a pre-requisite to achieving change.

We hope the views expressed in this letter will help inform your on-going deliberations.

Yours sincerely

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