



CHOICE IN THE UK AUDIT MARKET

FRC UPDATE

APRIL 2007

At the second stakeholder meeting on Audit Choice, held on 18 September 2006, there was strong support for the proposition that further work was needed to develop and fully assess the range of possible steps to mitigate the risk of uncertainty and disruption were one of the Big Four firms to leave the market for audit services to large public interest entities. This report summarises the work that has been carried out since that meeting.

Market Participants Group

It was suggested at the stakeholder meeting that the FRC should maintain the momentum of the debate over audit choice by seeking consensus over what different stakeholders could do to produce a collective improvement. To facilitate this process, the FRC proposed to convene and support a Market Participants Group (MPG). This Group would advise the FRC on which market-led steps to mitigate risks could be most effective and how these could be implemented. Nominations for membership of this Group were invited and were considered at the FRC Council meeting in October.

The MPG consists of four representatives from the entities being audited, four from firms providing audit services, and four from shareholders and other users of audit services. Members were appointed as individuals, based on their knowledge of the preparation or use of audit reports and the auditor selection process and on their seniority. The FRC has convened and supported six meetings of the Group.

The FRC is grateful to the members of the MPG for their work in developing their interim report which has been published today. The provisional recommendations indicate that there is much that can be done by different market participants, with where necessary some support from regulators or legislators, to improve the characteristics of the audit market. It is important that a wide range of organisations read the report and respond to the consultation.

Regulatory activity

In addition to establishing the MPG the FRC also announced that it would liaise with other relevant regulators to consider possible regulatory actions. Given the views expressed at the second stakeholder meeting that the priority should be to identify market-led measures to increase choice in the audit market, it was not appropriate to consider regulatory or legislative interventions. However, as agreed at that meeting, the FRC has been discussing with other relevant regulators how best to support actions by market

participants. The FRC recognises that there could also be a need to consider new regulation or legislation if market actions were found to be ineffective.

The FRC's principal regulatory activity has focused on considering what steps that could be taken to reduce the risk of an audit firm leaving the market without good reason and to reduce uncertainty and disruption costs in the event of a firm leaving the market. The main result of this work will be an audit continuity plan that is intended to help ensure a continued supply of high quality audits in the event of the possible, or actual, loss of a major audit firm. Although relevant regulators have existing arrangements for how to work together to respond to potentially disruptive incidents concerning audit firms, and from time to time have needed to activate these arrangements, it was felt that more could be done to prepare actions that could be taken to respond to a crisis.

International developments

Audit choice and continuity continue to be the subject of international debate and the FRC has had several discussions with regulatory counterparts in other jurisdictions over the Choice in the UK Audit Market project.

Recent international developments include:

- Audit regulators, through the International Forum of Independent Audit Regulators, and securities regulators, through the International Organisation of Securities Commissions (IOSCO) have met to discuss contingency plans for dealing with the effects of the loss of a major audit firm on the financial markets. The European Group of Auditors' Oversight Bodies is also establishing a data base for the purpose of sharing information between public oversight bodies in crisis situations.
- The report of the Commission on the Regulation of U.S. Capital Markets in the 21st Century in March 2007 called on domestic and international policy-makers to 'seriously consider proposals by others to address the significant risks faced by the public audit profession from catastrophic litigation, as well as the Commission's suggestion that national audit firms be allowed to raise capital from private shareholders other than audit partners.'
- The January 2007 report, Sustaining New York's and the US' Global Financial Services Leadership, recommended reform of securities litigation including evaluation of a cap on auditors' damages for securities-related infractions. A similar recommendation was made in the November 2006 Interim Report of the Committee on Capital Markets Regulation.
- The European Commission published an independent study of the economic impact of auditor liability rules in October 2006 and consulted on possible reform of liability rules in the EU in January 2007. It has also commissioned an independent study on ownership rules applying to the audit firms and their consequences on audit market concentration.

Next steps

The Financial Reporting Council is to hold a stakeholder meeting on Thursday 10 May in London to discuss the provisional recommendations of the MPG. Following a presentation of the Group's findings, participants at the stakeholder meeting will have an opportunity to discuss their preliminary reactions to the interim report. The meeting is intended to assist stakeholders as they begin to develop their responses to the MPG's recommendations.

Responses to the consultation over the interim report are requested by Friday 6th July. The responses and a summary of them will be posted on the FRC's website. The Group is likely to issue its final report in the Autumn of 2007.

Several of the provisional recommendations are directed at the FRC. The FRC's Regulatory Strategy sets out how changes to regulation are assessed and consulted over. The costs and benefits of the proposed actions would be evaluated alongside alternatives including a 'no-change' option and there would be consultation over any proposals for change.