



CHOICE IN THE UK AUDIT MARKET

FRC UPDATE

OCTOBER 2007

Introduction

This FRC Update on the Choice in the UK Audit Market project sets out the FRC's response to the advice of the Market Participants Group's (MPG) final report. It describes how the MPG's recommendations will be implemented including actions to be taken by the FRC. It also summarises progress made since the last FRC Update in April 2007 by regulators in the UK and internationally in reducing risks to the availability and quality of audits.

Implementation of the MPG recommendations

The MPG has published its final report setting 15 recommendations for changes intended to enhance the efficiency of the audit market and to mitigate the risks associated with a firm leaving the market. The recommendations are consistent with stakeholders' preference for market-led actions rather than regulatory interventions. They are substantially unchanged from the MPG's provisional recommendations published in its Interim Report, for which there was broad support.

The tables on pages 3 to 7 summarise how the MPG's recommendations will be implemented. The recommendations are ultimately targeted to audit firms, companies and investors, although in some cases enabling actions by professional bodies, regulators or legislators may first be needed and these are shown in the tables.

Any material changes to regulatory arrangements will be assessed for proportionality and effectiveness, with stakeholders being consulted before decisions are taken.

Regulatory actions outside scope of MPG

It is likely to take some years before the efficacy of the actions proposed by the MPG can be assessed. The FRC will monitor the implementation of the recommendations but currently believes that it is appropriate not to take any further regulatory action in respect of objective A, increased choice of auditors.

For objective B, reduced risk of a firm leaving the market without good reason, and objective C, reduced uncertainty and disruption costs in the event of an audit firm leaving the market, there could be a greater need for regulatory action. The FRC has been working with other regulators to prepare 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. It should be noted, however, that the ability of regulators to avoid uncertainty and disruption in the markets is limited.

International

Audit choice and continuity continue to be the subject of international debate. International developments since the last FRC Update in April include:

- In May the US Treasury announced that it will charter a non-partisan federal advisory committee to develop recommendations on ways to strengthen the auditing profession. Former SEC chairman Arthur Levitt and former SEC chief accountant Donald Nicolaisen were asked to co-chair the advisory committee and the full membership of the committee was announced in October (see <http://www.treas.gov/offices/domestic-finance/acap/>). The committee will examine auditing industry concentration, financial soundness, audit quality, employee recruitment and retention, in addition to other topics. The US Treasury expects the committee to produce findings and recommendations by early summer 2008.
- The European Commission published responses to its consultation on possible reform of liability rules in the EU in June. The EC-commissioned independent study on ownership rules applying to the audit firms and their consequences on audit market concentration is expected to be published shortly.
- Observers from international regulatory organisations attended the FRC's stakeholder meeting discussing the MPG's Interim Report that was held in May and held further discussions.
- The International Organization of Securities Commissions is identifying the range of possible considerations by securities regulators in the event of a crisis relating to a major audit firm.
- At the International Forum of Independent Audit Regulators meeting in Toronto in September 2007, IFIAR members received reports on the steps taken in some jurisdictions to examine the issues of concentration and choice in the audit market.

Monitoring

The FRC will make a public report every six months on progress in implementing the recommendations. Key Facts and Trends, an annual publication of the FRC's Professional Oversight Board, will monitor concentration in the market.

Implementation arrangements for recommendations targeted at audit firms

<i>MPG recommendation</i>	<i>Efficient market characteristics</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
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.	A.1.1: Increased actual capabilities of non-Big Four firms.	FRC to prepare and consult on discussion paper on the possible effects on audit choice of changes to audit firm ownership rules	Q2 2008
		FRC to use discussion paper to influence legislative change in the European Union and the US.	2008
		Existing or new non-Big Four Firms consider raising substantial equity finance.	2010?
2: Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.	A.1.2: New firms with the capabilities required by public interest entities enter the market	Guidance for the voluntary disclosure of financial results of audit work to be prepared.	Q2 2008
		Firms start to report on a voluntary basis using the guidance.	2009
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.	A.1.3: Non-Big Four willing to be appointed as auditor of more public interest entities.	FRC to send the recommendation to the working group preparing guidance on auditor liability limitation agreements, the European Commission, the US Treasury and other relevant authorities.	October 2007 & ongoing
		Further consideration of policy in European Union and the US.	2008
		Existing or new non-Big Four firms consider further investment.	2010?
4: Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.	A.1.4: More accurate perceived capabilities of non-Big Four firms.	FRC to review policies on membership of their boards and committees.	Q2 2008
		FRC to send recommendation to International Auditing and Assurance Standards Board, the International Accounting Standards Board, and member bodies of the Consultative Committee of Accountancy Bodies.	October 2007
		Non-Big Four firms demonstrate their involvement in standard setting bodies and committees.	2008 onwards

<i>MPG recommendation</i>	<i>Efficient market characteristics</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
5: The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency by the firms and the FRC of the capabilities of individual audit firms.	A.2.1: Increased understanding of audit quality and of the capabilities of individual firms.	The FRC has recently published a paper setting out the drivers of audit quality, based on an earlier discussion paper.	Q4 2007
		Firms report publicly on their capabilities in line with the drivers of audit quality. The Audit Inspection Unit will monitor and report publicly on firms' capabilities in line with the drivers of audit quality.	From 2008
6: The auditing profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.	A.2.2: Reduced risk and cost of changing auditors.	The Joint Audit Committee (JAC) of ICAEW, ICAS and ICAI is in the process of developing guidance for their members to allow successor auditors access to all relevant information held by their predecessor in respect of the last audit report signed by the predecessor.	Q2 2008
		Firms start to follow new arrangements. Audit Inspection Unit considers effectiveness of new arrangements.	From Q3 2008
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.	A.3.1: Only necessary factors constrain supply to major public interest entities.	The Auditing Practices Board is reviewing the ethical standards. Whilst the focus is on achieving high standards of auditing, the APB will consider the proportionality of the standards. In so doing it will have regard to the views raised in this debate on particular ethical standards.	Q2 2008
		FRC to send recommendation to the International Ethics Standards Board for Accountants and the SEC.	October 2007
		Firms compete for audits taking account of any changes to the ethical standards.	From 2009
14: Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.	B.2: Reduced value of meritorious claims against audit firms.	The ICAEW to form a working group to develop a Combined Code -style best practice corporate governance guide for auditors of public interest entities.	Q4 2008
		Firms consider and follow the new corporate governance guide.	From 2009

Implementation arrangements for recommendations targeted at companies

<i>MPG recommendation</i>	<i>Efficient market characteristic</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
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.	A.2.3: Companies more willing to appoint auditors from more than one network.	FRC to prepare draft guidance and publish this for comment.	Q4 2007
		FRC to publish and distribute the final guidance.	Q2 2008
		Companies consider guidance.	Q3 2008 onwards
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.	A.2.4: Clearer information on boards' auditor selection decisions.	The FRC will prepare revised guidance for audit committees (the Smith Guidance).	Draft revised guidance to be published for comment Q1 2008 and finalised by Q3 2008. Companies consider guidance Q3 2008 onwards
9: When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms	A.2.5: Corporate advisers and brokers more willing for clients to appoint non-Big Four.		
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.	A.3.2: Only necessary factors constrain use of Big Four by major public interest entities.		
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.	C.1: Actions taken before the possible loss of an audit firm.		

<i>MPG recommendation</i>	<i>Efficient market characteristic</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
13: Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.	B.1: Appropriate response by the market when issues arise.	FRC and its operating bodies to review policies on regulatory penalties and publish for discussion outline details of any proposed changes. The FRC will also raise the matter with its regulatory counterparts in other major jurisdictions.	By Q3 2008
		Companies consider their response to any audit firm incident taking account of available information on regulatory penalties.	2009 onwards

Implementation arrangements for recommendations targeted at investors

<i>MPG recommendation</i>	<i>Efficient market characteristic</i>	<i>Implementation arrangement</i>	<i>Expected timing</i>
10: Investor groups, corporate representatives, firms and the FRC should promote good practices for shareholder engagement on auditor appointment and re-appointments.	A.2.6: Increased shareholder engagement on auditor selection.	Investor groups consider information published by companies through recommendation 8 and firms through recommendation 2, 5 and 14.	Starting 2008
		Investor groups consider need for any revisions to existing guidance on shareholder engagement on auditor selection in light of availability of improved information described above.	Starting 2008