



## **CHOICE IN THE UK AUDIT MARKET**

### **KEY POINTS FROM STAKEHOLDER MEETING HELD ON 18 SEPTEMBER 2006 AT THE ROYAL INSTITUTE OF BRITISH ARCHITECTS**

The Financial Reporting Council (FRC) held a second stakeholder meeting on 18 September 2006 as part of its consultation over the public interest issues that may arise from the existing competitive environment for audit services to large listed companies in the UK and how these issues might be addressed. Around 110 people attended the meeting. The meeting discussed the consultation process to date, six tentative propositions regarding risks and how these might be mitigated, and next steps.

#### **Process to date**

The process to date was summarised. In September 2005 the Department of Trade and Industry and the FRC jointly commissioned a study, "Competition and choice in the UK audit market". The study was published in April 2006 and the findings had been discussed at the first stakeholder meeting held in April. The FRC published a Discussion Paper in May 2006 that had sought views on the nature of the risks arising from the characteristics of the audit market, the potential implications if any risks are realised, types of opportunities for mitigating such risks, and the potential effectiveness and proportionality of particular steps to mitigate risks. There had been a strong response from stakeholders to the Discussion Paper with over 100 steps suggested for mitigating risks.

There was a discussion over whether the focus of the debate should be over the degree of choice available to large companies. It was suggested that the degree of choice needed to be considered alongside wider aspects of the market, including the quality of audit services, audit pricing, auditor liability and the risk that firms could have undue influence over regulators.

#### **Propositions**

The meeting then discussed the six tentative propositions which had been developed by the FRC based on the responses to the Discussion Paper. The propositions, followed by views expressed on them, are shown below:

- Proposition 1: There would be significant risks to the availability and quality of audits if one of the Big Four firms was to leave the market.
  - Risks arising from the existing level of concentration in the market should also be considered.
  - There should be a focus on audits for major quoted and multinational companies.
  - There should be a focus on the risk of a Big Four firm leaving the market globally rather than only in one national market.

- Evidence would be needed to support any assertion that audit quality was linked to the availability of audits from the Big Four firms.
- The debate, and the market, should be better-informed on the different characteristics of the audit market in different industry sectors.
- Proposition 2: These risks could be mitigated if there was: Increased choice of auditor for public interest entities; reduced risk of an existing firm leaving the market without good reason; and reduced costs of uncertainty and disruption in the event of a firm leaving the market.
  - Market forces should be allowed to determine choice without 'artificial' intervention.
  - There would need to be increased participation of auditors in the market, not just increased choice.
  - The term 'without good reason' should be clarified, partly to avoid a perception that the Big Four firms could not be allowed to fail.
- Proposition 3: No single measure can address all of the risks identified but a considerable number of possible steps have been suggested by stakeholders.
  - No comments were offered on this proposition.
- Proposition 4: Further work is now needed to develop and fully assess the range of possible steps to mitigate the risks identified.
  - Any further work should take into account recent changes to the auditing profession, the effects of which may not yet be clear.
  - The FRC should maintain the momentum by seeking consensus about what different stakeholders could do to produce a collective improvement.
  - Further work should be split between practical steps that could be taken in the near future and a more systemic look at audit.
  - The proposition could be improved by including an indication of the main concerns.
  - More work was needed to analyse the current situation and its implications, particularly around the risks, rewards and incentives of the audit firms.
- Proposition 5: In developing and assessing possible steps, the priority should be on those steps that can be taken by market participants. Any regulatory actions need to be subject to a thorough Regulatory Impact Assessment.
  - Although the priority should be on market-led measures, regulatory or deregulatory changes might be needed and should be looked at in parallel.
  - Some possible steps could have very damaging consequences and assessments should be based on strong research-based evidence.
  - In assessing options, audit quality should be the paramount consideration.

- Proposition 6: Debate on these propositions within the UK will make a useful contribution to the international debate on these risks.
  - More visible involvement of chairmen and audit chairs of the UK's largest companies would result in a more useful contribution to the international debate.
  - A useful contribution from the UK would be to demonstrate that dealing with auditor liability in isolation would not be sufficient to solve all problems with the audit market.

In responding to these points, the FRC noted that:

- On keeping choice separate from quality considerations, while it would not be wise to entirely compartmentalise all issues related to the audit market, neither would it be wise to try to deal with all issues in a single project. The FRC would publish a paper on the drivers of audit quality later in the year.
- The FRC preference was for market-led solutions, but recognising the possibility that market participants might not be able to agree on all the solutions, then some regulatory action may be required. Nothing was being ruled in or out at this stage, although some things could be achieved more quickly than others.
- The presence of a number of overseas regulators at the meeting was an indication of their interest in the developments in the UK.

### **Next steps**

In introducing proposed next steps, the FRC noted that among the many steps suggested to mitigate risks some could be implemented by individual organisations. There were examples of such steps already being taken by firms and institutional shareholders.

Some steps to mitigate risks would require the participation of a combination of market participants to be effective. To help facilitate the selection and development of these steps, the FRC proposed to convene and support a Market Participants Group. 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 would be considered at the FRC Council meeting in October. The composition of the Group would be published in October. There would then be a progress report during the first quarter of 2007 and the usefulness of a further stakeholder meeting at that stage would be considered.

In parallel with the work of the Market Participants Group, the FRC would be liaising with other relevant regulators to consider possible regulatory actions.

To help monitor the effectiveness of the steps being taken, statistics measuring the degree of concentration in the market would be included in the Professional Oversight Board's annual publication 'Key Facts and Trends'.

Several stakeholders expressed support for the proposal of a Market Participants Group. Other views on the next steps included:

- There was a role for the FRC as regulator to take the lead in helping the market to prioritise the issues. Without that leadership, there was a danger that some of the good ideas would be lost.
- A further stakeholder meeting would act as a good catalyst for ensuring sensible actions were taken in a reasonable timescale.