



Choice in the UK Audit Market

The ABI's Response to the FRC's consultation on the Interim Report of the Market Participants Group

Introduction

This paper is the response of the Association of British Insurers (ABI) to the FRC's April 2007 consultation on the Interim Report of the Market Participants Group. Our response reflects ABI members' particular interest as institutional investors holding some 20% of the shares of UK-listed companies in ensuring effective competition and choice in the audit market which in turn are important drivers of audit quality.

General Comments

We welcome the FRC's initiative and the efforts of the Market Participants Group.

In responding to the May 2006 consultation on the FRC's discussion paper on Competition and Choice in the Audit Market we conveyed that the incremental effect of a range of measures had the best prospect of providing some improvement. There is no straightforward problem to which there is a single answer. Liability reform of itself is not a sufficient solution. We also said that we regarded regulatory capture as a significant risk associated with the current level of concentration in the market.

The complexity of client relationships including in respect of non-audit work that poses significant practical restrictions and constraints on choices exercised by listed companies. In particular, large companies, and not only those in the FTSE100 index, financial sector entities are particularly affected. It is in this context that the level of concentration and the impact this has on competition and choice needs to be assessed.

Incremental growth by Tier A audit firms is desirable so that in larger capitalisation stocks the market is at least contestable. This growth can be achieved in various ways, including through growth of non-audit work, but the success of the smaller firms in developing their business must depend on merit. It is not acceptable that arguments of "too big to be allowed to fail", which have at times been advanced by supporters of the Big 4 firms, be allowed to drive public policy.

Our Investment Committee issued a statement in June 2006 encouraging greater diversity and choice and making clear that in choosing a new auditor the appointment of a Big 4 firm should not be the default choice for all listed companies. We hope that, over time, the adoption of this approach will lead to a reduction of concentration, particularly for companies at the middle and lower end of the market.

It is the culmination of this and other incremental measures that should help achieve the desired improvement in the competitive environment for audit services. It will be important, though, that the FRC continues to monitor progress.

Questions for Consultation

We support the three criteria used for assessing the merit of the provisional recommendations, viz effectiveness, quality and cost. Our response to the question of the appropriateness of each of the Market Participants Group's provisional recommendations is as follows:

Provisional Recommendation 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

The significance of audit firm ownership rules to the business environment in which these firms operate should not be underestimated as it affects firm structure, availability of capital, propensity to use insurance. Although there may not be a strong desire for change from current arrangements it should not be assumed that this will necessarily remain the case and it is desirable to give serious thought to the implications of change. The question is right to link this to availability of sufficient safeguards to protect auditor independence and quality. It is unclear to us precisely what these safeguards would be but greater transparency on governance matters provides some of the answer. (see also our response to Q 14). In principle, though, it is difficult to see a compelling public policy rationale for retaining restrictive ownership rules if these safeguards are present.

The particular significance of the ownership rules and their impact on competition and choice may well become apparent in circumstances of firm distress. Recapitalisation of an entity will not be helped by restrictions that tie firm viability in these cases to capability to recruiting audit partners with financial resources to be injected into the business. Given the public policy concerns around the putative collapse of a big 4 audit firm it should at least be incumbent on the FRC, as domestic regulator together with counterparts at European level to give thought to this in order that appropriate policy responses are capable of being implemented at some future date when the need for change may quickly become acute.

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

Yes, this is relevant information that we would expect to be in the public domain. Given the importance of the subject it is disappointing that relevant information necessary to make informed judgments has been lacking.

Provisional Recommendation 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.

Yes, this is the right policy principle and it is important that this balanced approach of a focus both on choice and quality be maintained. In practical terms it is not, though, for regulators to deliver choice. This is something that derives from the operation of the market.

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

Yes, this is an important recommendation. Implementing it will help to dispel any perceptions that the leading audit firms exercise a disproportionate influence on the regulatory authorities.

Provisional Recommendation 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.

The FRC should be commended for its November 2006 consultation on “Promoting Audit Quality” and we were pleased to respond to it. It is important that the responses to this consultation be carefully considered and that decisions then be taken about how best to take this strand of work forward.

Provisional Recommendation 6: The accounting profession should establish mechanisms to improve access by incoming auditor to information relevant to the audit held by the outgoing auditor.

Effective competition and choice in the audit market requires that the process of change from one auditor to another be kept as smooth and seamless as possible. The process of change has been characterised both as increasing the risk of reduced auditor effectiveness as the learning curve is traversed but also as focusing the mind of the departing auditor that might lead to difficult matters being addressed rather than left as unfinished business from one audit period to the next.

Provisional Recommendation 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.

This is an important area since it goes to the heart of the debate about the benefits of an international network and the competitive advantage that may accrue dependent on the existence or quality of such a network. However, the consultation document rightly recognises that the use of different auditors for group and subsidiary accounts can be a way of introducing a second pair of eyes that may enhance audit quality. This approach therefore has potential benefits as well as likely additional costs. Audit committees need to take an informed view on this.

It is important to remember that the auditor of the parent company takes responsibility for the accounts, including the consolidated accounts, of the parent entity and that auditor must therefore take its own view on the veracity of accounting information relevant to subsidiaries. Reliance on the work of other firms in the international network cannot be regarded as acceptable as an alternative to due diligence as would be appropriate where an audit firm outside the network acts as a subsidiary auditor.

Provisional Recommendation 8: The FRC should amend the section of the Smith Guidance with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision.

Refreshment of the Smith guidance would be helpful. Communication by Boards and Audit Committees with shareholders on this subject is of central importance and helps for more informed decision making on the resolution to approve the auditor appointment recommended by the Board.

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

Yes, as we said in our response last year, the existence of restrictions, such as in loan covenants, to require the employment of Big 4 auditors are unlikely to have been put in place as an anti-competitive device but that may be a practical effect. Transparency as to any such requirements will enable proper scrutiny of whether such restrictions are genuinely necessary or should be modified.

Provisional Recommendation 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.

Dialogue with audit committees is one aspect of responsible shareholder engagement with boards. In practice such engagement has been relatively limited in extent and we consider it desirable that encouragement be given to increasing its prevalence. However, we would not think it helpful to prescribe the nature or scope of such discussions. Broadly speaking we see existing guidance within the Combined Code, complemented by that produced by other bodies such as the Institutional Shareholders' Committee focusing on the responsibilities of shareholders, as being sufficient. However, all parties should keep such matters under review.

The ABI has already considered the question of whether the concept of holding an advisory vote on the adoption of the audit committee report has merit. Our members are unconvinced of the benefits and we have concluded that the existing binding vote on appointment or reappointment of auditors remains the appropriate focus for shareholders formally to opine on matters relevant to the audit process. At present the level of reporting by audit committees to shareholders is relatively

limited and does not provide sufficient material to justify a separate vote from a practical point of view. The principled case is also unclear despite the superficial analogy with the vote required to be held on adoption of the report on directors' remuneration. However we do consider, though, that enhanced reporting by audit committees to shareholders would be helpful in facilitating informed shareholder engagement between shareholders and audit committees

Provisional Recommendation 11: Authorities with responsibility for ethical standards for auditors should consider whether any rules could have disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.

We support this recommendation in principle as well as the underlying objective of avoiding a disproportionately adverse impact on auditor choice. However, we emphasise our view that we are opposed to any weakening of the ethical standards expected of auditors and we are not ourselves aware of any rules that could have a disproportionately adverse impact on auditor choice.

Provisional Recommendation 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.

It is important that audit committees should have oversight of this and be able to make their own judgments. The Smith guidance, whether revised or not, should exist to support them in their role and should not be seen as a compliance-based code that prompts a favourable view merely because the matter does not contravene the APB's guidance.

We are concerned at the implicit suggestion in this question that there might be some weakening of the requirements regarding independence and of the scope of audit committees to take an adverse view in circumstances where this seems the right course.

Provisional Recommendation 13: Regulators should develop protocols for a more consistent response to audit firms issues based on their seriousness.

We consider it important that regulators should be empowered to exercise their judgment over what will be difficult decisions in circumstances that cannot be foreseen in detail. There is a therefore a danger that seeking to tie regulators down to acting in accordance with 'protocols' will reduce their room for manoeuvre.

Provisional Recommendation 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.

The business of an audit firm has a major public interest perspective and the case for transparency is higher than it would be on other grounds. Notwithstanding that these firms are not themselves listed companies with a need to report to their own

shareholders in this way there is a strong case for requiring a level of transparency and disclosure required of listed companies including relevant aspects of risk management. Compliance with the Code, or with analogous tailored provisions, has become seen as a mark of adherence to best practice in a number of non-listed company contexts, for example larger mutual insurance companies.

The audit firms themselves are large businesses, a characteristic that belies their partnership structure. There is a case for recognising size of audit firm as a relevant criterion for triggering Code reporting expectations possibly in addition to or in place of the criterion relating to size and type of audit client. We would not wish to introduce a new barrier to smaller audit firms wishing to undertake, say, a small number of audits of public interest entities.

If audit firms are to report their compliance or otherwise against the Combined Code under a 'comply or explain' framework then it is necessary that the compliance statements are read and that dialogue can take place around the quality of explanations for departures made from the Code provisions. The best-placed parties to do this are the actual and potential clients of the audit firm. Accordingly we would encourage audit committees to make annual consideration of these disclosures a standard matter for their agenda.

Provisional Recommendation 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.

This is clearly an important risk that companies need to be aware of and plan for to the extent that this is possible. However this is unlikely to enable companies to gain a high level of assurance that contingency plans can be devised and be capable of being put into operation in all conceivable circumstances of failure of an audit firm. The regulatory response would be a very relevant factor and we anticipate the FRC has itself given thought to what temporary or permanent changes are required in its stance (see also our response to Recommendation 1 on ownership structure of audit firms).

Where capacity in the market for audit of listed companies would exist in such circumstances will be determined to a significant degree by where qualified audit staff wish to work and the terms under which other firms are able to accommodate them. It is to be hoped that other firms, particularly those that do not already have a high market share, will wish to take the opportunity to develop their client base and that listed companies that until hitherto have been reluctant to appoint an auditor from outside the ranks of the top tier firms would respond in the changed circumstances by revising this stance.

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