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Dear Julian

Choice in the UK Audit Market – Interim Report of the Market Participants Group

IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of nearly £3 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in those companies' accounts and the information disclosed to our members as users. In this respect, IMA believes that a well functioning market for audit services is essential to ensuring confidence in corporate reporting. The fact that the Big Four dominate the audits of practically all companies in the FTSE 350 is not healthy for competition or choice. Nor do we believe it likely that there will be an organically developed competitor to them in the medium term. Furthermore, the situation could be exacerbated in that there is a risk that one of the Big Four could fail. Therefore, we welcomed the FRC establishing the Market Participants Group (MPG) to look at choice in the UK audit market and creating a platform for stakeholders to comment on the matter.

In general, IMA supports the MPG's provisional recommendations and hopes that once they are finalised, the FRC will seek to encourage the relevant market

participants to implement them as a matter of priority. Our comments on the specific questions raised and on the individual provisional recommendations are set out in the attached. Our main comments are summarised below.

- Investors would welcome more transparency on firms' capabilities and on the quality of audits. Thus our members would value information on an audit firm's governance, client profiles, quality control procedures and the policy issues it faces so that they are better informed and to help them clarify their preferences between different firms. Provisional recommendation 5 goes some way to address this but we consider it could be strengthened so that, if requested, auditors of public interest entities engage with major shareholders.
- We welcome the fact that the recommendation on auditors' liability arrangements is "subject to the overriding need to protect audit quality" (provisional recommendation 3). Our members are increasingly concerned about the quality of audits and although we welcome the fact that the FRC issued a discussion paper on audit quality late last year, we consider the FRC and MPG should be looking at choice and quality together.
- We support different sizes of audit firms participating on standard setting bodies and committees (provisional recommendation 4) but would welcome a broader constituency being involved in the development of audit standards in that, as well as smaller audit firms, investors and companies should be given the opportunity to participate.
- We believe one of the key reasons behind the merger of a number of audit firms some years ago was the increasing globalisation of companies. In merging to form a multinational audit network, a firm sought to minimise the risks and costs of auditing a large multinational company. We consider encouraging the use of firms from more than one audit network (provisional recommendation 7) could be a retrograde step. Therefore, before this recommendation is adopted, we believe there should be a wider discussion of the implications of using firms from more than one audit network and would welcome the opportunity of participating in the same.
- We consider provisional recommendation 8, that the Smith Guidance should be amended so that shareholders are provided with information on the auditor selection process, could be strengthened so that audit committees also make themselves available, if necessary, to explain to major shareholders any changes of auditor and if shareholders request they should consult them on the selection of an alternative from a wider range of firms. At present, shareholders ratify the appointment at the Annual General Meeting and are not involved in the selection process.
- We do not consider that there should be a vote on the audit committee report (provisional recommendation 8) in that we:

- do not believe that such a vote would necessarily improve the quality of reporting by audit committees - indeed it could potentially encourage more boilerplate reporting which would be a retrograde step;
 - question whether such a measure would increase engagement on auditor reappointment, as put forward in the paper, in that investors already engage with companies and do not necessarily have to vote on a matter before they do so; and
 - doubt if a vote would help improve choice in the audit market – the main objective of the paper.
- As regards the provision of non-audit services to audit clients, we consider it can lead to cross-subsidisation and underbidding for “foot in the door” opportunities. Thus it can create a barrier for smaller firms that do not have the capacity to provide such a wide range of services. IMA would not support such services being prohibited but considers there is a case for restricting them.
 - IMA supports the application of the Combined Code to audit firms (provisional recommendation 14). However, it needs to be clarified who would ensure that audit firms give the disclosures required and who would ensure the disclosures are acceptable - audit firms are not listed do not currently have outside shareholders.

Please do contact me if you would like clarification on any of the points in this letter or the attached, or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall
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IMA RESPONSE TO CONSULTATION QUESTIONS – THE MARKETS AND PARTICIPANTS GROUP.

IMA's answers to the specific questions raised are set out below.

The MPG has set out three criteria for assessing the provisional recommendations.

- Whether actions would, when combined with others, contribute to achieving the intended outcomes.
- Whilst at least maintaining audit quality.
- At a cost which is proportionate to the likely benefits and which is lower than alternatives offering equivalent benefits

Do you support the three criteria used for assessing the merits of the provisional recommendations, as set out below? If not, please proposed preferred criteria.

IMA considers that these criteria are important and should be looked at together. Furthermore, whilst choice in the audit market is important, our members are concerned lest the FRC focuses too much on preventing the failure of one of the Big Four, giving them more protection and cementing their position, at the expense of essential longer term reforms. In particular, they are concerned about the quality of audits, especially in view of the liability reforms in the Companies Act 2006 – exposure to liability induces service providers to be more diligent and reducing it could induce a lower quality of service. Whilst we welcome the fact that the FRC issued a discussion paper on audit quality late last year, we consider the FRC and MPG should be looking at choice and quality together.

The MPG considers that a package of provisional recommendations could impact the concentration in the supply of audit services to all but the very large public interest entities over the medium term. In the longer term, it considers that this may provide a platform for non-Big four firms who respond to the opportunities created to enter the audit market for large public interest entities. It also considers that the provisional recommendations could reduce the risk of an audit firm leaving the market without good reason and contribute to mitigating the uncertainty and disruption that would result.

In relation to each recommendation, the paper asks

- ***Do you support the stated objective of the recommendation?***
- ***Do you agree with the assessment of the recommendation or if not, why not?***
- ***What alternative or additional recommendations could achieve the desired objective in a way that meets the assessment criteria?***

Our comments are set out below for each of the 15 recommendations.

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.

In general, IMA supports this recommendation. In particular, as noted in the paper “the ability of existing or new audit firms to raise substantial external equity finance for investment is limited” and “some existing non-Big four firms may be limited in the degree by which they can rely on partners’ funds to make a step change in the level of investment in capacity to deliver audit services to the FTSE 350 segment¹”.

IMA believes that the ownership rules should be reviewed and that there may be other benefits in changing them so that:

- non-executives can be appointed to a firm’s governing body to facilitate its operation and effectiveness; and
- there is more competitive differentiation between firms.

Furthermore, we note that the European Commission has commissioned a study on ownership rules and the effect these have on market concentration. Ideally the FRC should plan to promote an understanding of the ownership rules so that they can be informed by the results of this study.

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

In principle, we support this provisional recommendation. That said, we are not convinced that providing the market with information on the profitability of audit work will necessarily ensure new entrants. Furthermore, whilst financial results of statutory audits and related services are interesting to shareholders, focusing too much on this aspect may exacerbate concerns about firms focussing on revenue at the expense of audit quality. We set out under provisional recommendation 5 the types of information investors would value.

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.

In principle, IMA supports liability reform and welcomes the FRC establishing a group to develop guidance on auditor liability agreements. Whilst we welcome the fact that the provisional recommendation emphasises quality in that it states “subject to the overriding need to protect audit quality” and that the FRC issued a discussion paper on audit quality late last year, we consider the FRC and MPG should be looking at choice and quality together.

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

IMA supports this provisional recommendation and considers it important that the credibility and legitimacy of standards are promoted through the process by which they are developed. In the past our members have been concerned about the governance of the bodies that set International Standards on Auditing (ISAs) in that it is the responsibility of the International Audit and Assurance Board which is part of the International Federation of Accountants (IFAC) which is funded by the accountancy professional bodies and the large audit firms.

We welcome the steps taken to address this through the establishment in 2005 of the Public Interest Oversight Board (PIOB) to oversee standard setting and revisions to IFAC's constitution. The PIOB has representatives from the International Organisation of Securities Commissioners, the Basle Committee on Banking Supervisors, the International Association of Insurance Supervisors, the European Commission and the World Bank. Whilst we hope that in the future this measure will guard against the potential for standards being compromised by the interests of the large firms, we would welcome a broader constituency being involved in the actual development of ISAs and, as well as smaller audit firms, investors and companies should be given the opportunity to participate.

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.

IMA supports the provisional recommendation that the FRC should continue to promote an understanding of audit quality and greater transparency of the capabilities of individual audit firms. If audit firms disclose more information on matters such as their governance, client profiles, quality control procedures and policy issues faced, it will help better inform major shareholders and help them clarify their preferences between audit firms. In turn, they could make it clear, as a number have already, that they do not necessarily expect companies to select an auditor from one of the Big Four.

Due to the importance of this, we consider the recommendation could be strengthened to recommend that, if requested, auditors of public interest entities should engage more with major shareholders. This could help ensure that major shareholders are better informed and would better manage their expectations.

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

IMA supports the accounting profession establishing mechanisms to improve access by the incoming auditor to relevant information held by the outgoing auditor. Changes of auditor can be costly for both the company and the incoming firm - the latter has to quickly learn the company's business. It is also understood that there

can be a higher risk of audit failure when an audit firm takes on a new client due to its lack of detailed knowledge of the company's business. Thus we welcome

measures that reduce the costs and risks of changing auditors as this should help increase the choice and options for change in the audit market. Furthermore, we consider it would be helpful if the extent to which outgoing firms provide quality information to incoming firms in a timely manner was included in the scope of the Audit Inspection Unit's reviews of firms.

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.

IMA has concerns about promoting the use of firms from more than one audit network. Some years ago, the large audit firms underwent a series of mergers resulting in the Big Five, and due to the loss of Andersons, the Big Four today. We believe that one of the key reasons for these mergers was that they were a response to the increasing globalisation of companies and sought to minimise risks and costs of using firms from one network to audit a large multinational company. Therefore to encourage participants to use firms from more than one audit network could be a retrograde step. We believe there should be a wider discussion of the implications of this recommendation before it is adopted and would welcome the opportunity of participating in the same.

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.

IMA supports the FRC amending 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. However, we are concerned in case this results in unhelpful, boilerplate disclosures and would welcome it being strengthened so that audit committees also make themselves available, if necessary, to explain to major shareholders any changes of auditor and if shareholders request, they should consult them on the selection of an alternative from a wider range of firms. The main issues on the reappointment of auditors that investors would like assurance on are:

- the value given and the firm's branding; and
- the quality of service.

Improved dialogue would also help shareholders support audit committees in responding to new information about potential problems faced by audit firms and in responding to the loss of a firm. At present, shareholders ratify the appointment at the Annual General Meeting and are not involved in the selection process.

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

As identified in the paper, IMA agrees that there needs to be “improved explanation from Boards of auditor appointment decisions. In cases where advice or requirements from corporate advisers and bankers formed an important part of the Board’s decision then it would be relevant for this to be explained to shareholders²”.

In particular, when explaining auditor selection decisions, Boards should disclose any obligations to appoint certain audit firms. We consider that this could lead to a more open discussion over advice given and market pressure on the advisers or banks to change their position.

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.

IMA supports the development of good practices for shareholder engagement on auditor appointment and re-appointments – see our comments under provisional recommendation 8.

However, we do not consider that there should be a vote on the audit committee report. First, we do not believe that such a vote would improve the quality of reporting by audit committees - indeed it could potentially encourage more boilerplate reporting which would be a retrograde step. Secondly, we question whether such a measure would increase engagement on auditor reappointment in that investors already engage with companies and do not necessarily have to vote on a matter before they do so. Lastly, we doubt if a vote would help improve choice in the audit market – the main objective of the paper.

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.

IMA would welcome the relevant authorities reviewing whether ethical standards adversely impact auditor choice when compared to the benefits of auditor objectivity and independence. In particular, the current rules on auditor independence mean that some companies have no real choice of auditor, for example an auditor cannot audit the accounts of its bank and as the Oxera report noted, “a small number of UK-listed companies, primarily in the banking sector of the FTSE 100, have no effective choice of auditor in the short run”. To address this it may be necessary for there to be some structural intervention, for example, although rules on auditor independence are important, there could be benefits in them being reviewed in order to increase choice.

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Furthermore, to ensure objectivity, we believe that the individuals responsible for an audit should change at intervals and support the UK requirement whereby the lead audit and independent review partners rotate. To prevent the loss of past knowledge, we also support other staff assigned to the audit remaining the same. The paper notes that the Government reduced the timescale for the rotation of the lead partner from seven to five years³. It is arguable whether rotation every five years is too frequent and whether every seven years would be more practical. In particular, requiring rotation every five years can be a barrier for mid-tier firms tendering for an audit, particularly if the partner needs to have specialist knowledge. In conclusion, this matter may benefit from some further consideration.

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.

We support this provisional recommendation. It would be confusing if two sets of regulation/guidance were interpreted different ways. Furthermore, as regards the provision of non-audit services to audit clients, we consider it can lead to cross-subsidisation and underbidding for “foot in the door” opportunities. Thus it can create a barrier for smaller firms that do not have the capacity to provide such a wide range of services. IMA would not support such services being prohibited but considers there is a case for restricting them.

13. Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.

IMA agrees that regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness. These should recognise that situations may arise which necessitate a regulatory response that would call into question the sustainability of the firm in question.

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.

IMA supports more transparency from audit firms as to their governance arrangements and would welcome all firms that audit public interest entities complying with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or giving a considered explanation if they depart from the Code provisions. In this respect, the FSA's listing requirements require that companies listed on the UK's main market disclose that they have complied with the Code's provisions or give a reasoned explanation where they have not. The FSA is responsible for monitoring whether companies make the disclosures required but not whether an individual company's disclosures are acceptable; this is done by the outside shareholders.

³ Page 41

As regards the application of the Combined Code to audit firms, it needs to be clarified who would ensure that audit firms give the disclosures required and who would ensure the disclosures are acceptable - audit firms are not listed and do not have outside shareholders.

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.

IMA agrees that 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. That said, the risks to the market and capital creation should one of the main audit firms withdraw from the market mean that the risks need to be considered by all market participants and not just those entities that are audited.

Are there other characteristics of a more efficient market which should be considered for inclusion in the report? What additional recommendations could contribute to the achievement of these other characteristics?

IMA has no other recommendations to make other than as set out above.