

Response to Choice in the UK Audit Market Interim Report of the Market Participants Group April 2007.

The Market Participants Group was established by the Financial Reporting Council to provide advice on actions that could be undertaken that would mitigate the risks arising from the characteristics of the market for audit services to public interest entities in the UK. The Group note that due to the level of auditor concentration there is a high degree of concern amongst market participants over the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. The Market Participants Group has proposed a set of actions (set out below) that they argue should, when combined with others contribute to increased choice whilst at least maintaining audit quality, at a cost which is proportionate to the likely benefits and at a cost which is lower than any alternatives offering equivalent benefits. The main aims of the recommendations are to:

- Make investment in the supply of audit services more feasible
- Reduce the perceived risks to directors of selecting a non-Big Four firm
- Improve the accountability of boards for their auditor selection decisions
- Improve choice from within the Big Four
- Reduce the risk of firms leaving the market without good reason
- Reduce uncertainty and disruption costs in the event of a firm leaving the market

The Market Participants Group issued several consultation questions:

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

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.

For each proposed recommendation:

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?

Are there any 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 those other characteristics?

The recommendations of the Market Participants Group and my responses are set out below.

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.

Response to recommendation

Wider understanding and/or a debate about the effects of changes of ownership rules is welcomed. I believe that the traditionally ownership (unlimited liability and recognised practitioner) rules were an entry barrier that contributed to a restricted supply of firms. Following such a debate, if ownership and liability rules were made less restrictive then this could open the door to new firms coming into the market and thereby increase choice and possibly reduce concentration. Any new firm(s) would need to have large resources, a good reputation and deep pockets to compete effectively. However, safeguards would need to be introduced to protect audit quality and avoid an Akerlof (1970) 'market for lemons' problem.

Recommendation

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

Response to recommendation

It is difficult for parties outside an accounting firm (e.g. audit committees) to judge whether they are receiving value for money from their auditors (McMeeking et al., 2006). Increased disclosure of the financial results of auditors might be welcomed by many audit committees. However, the recommendation does not specify the level of detail that must be provided. If audit firms were required to disclose financial results that are comparable with those of industrial companies then assessments of value for money are straightforward at the firm level. If audit firms were required to produce comparable results with each other (as I think the recommendation implies) then there may be an incentive to minimize the amount of information disclosed. I believe that increased disclosure would be useful, particularly in the light of recommendation 1.

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.

Response to recommendation

The promotion of choice is welcomed subject to the maintenance of audit quality and the protection of shareholders', debtholders' and creditors' interests.

Recommendation

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

Response to recommendation

The Big Four conduct the audit work of most of the large UK companies and receive huge fee streams. Regulatory organisations (e.g. FRC) are mainly represented by individuals from the largest companies and accounting firms. However, there are a large number of small and medium sized companies that hire a different auditor. Representatives from smaller audit firms could offer a useful different perspective on debates such as auditor choice. The 'one size fits all' model is not appropriate for all companies and may not be appropriate for all regulatory organisations.

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.

Response to recommendation

Audit quality is vitally important to the profession. Increased understanding of audit quality is welcomed as it is not clear to me that these terms are well understood by laymen. Increased transparency of the capabilities of firms should make audit committees question whether retaining their current auditor is the best policy. Reduced inertia will raise the probability of auditor rotation. It is not clear to me whether this recommendation will actually reduce concentration levels because medium sized companies that consider switching may be inclined to choose a Big Four firm and thereby increase concentration ratios further. Concentration ratios may fall if this recommendation is combined with measures to reduce the perceived risks to directors of selecting a non-Big Four firm and a concerted move to target companies by this group of auditors.

Recommendation

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.

Response to recommendation

This ought to reduce the costs of switching and is welcomed. I urge the FRC to think clearly as to how this can be enforced.

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.

Response to recommendation

I believe that a register of auditors could be kept containing firm name, contact details, partners and details of any industry specialisations (with supportive evidence). This register and independent guidance should make audit committees more aware of the choice in the market. The use of joint auditors is often perceived to be costly (possibly due to increased risk). The FRC must bear this in mind in this regard.

Recommendation

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.

Response to recommendation

This would be useful information provision.

Recommendation

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

Response to recommendation

This would be useful information provision. If one of the Big Four firms left the market then this group of companies could be exposed to severely restricted choice.

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.

Response to recommendation

Shareholder involvement is preferable but they must be incentivised to do so to avoid an unnecessary cost being placed onto companies.

Recommendation

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.

Response to recommendation

See below.

Recommendation

12. The FRC should review the independence section of the Smith Guidance to ensure that it is consistent with the ethical standards for auditors.

Response to recommendation

Increased focus on ethics in training, education and regulation is welcomed.

Recommendation

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

Response to recommendation

Agreed.

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.

Response to recommendation

Agreed.

Recommendation

15. Major public entities should consider the need to include the risk of withdrawal of their auditor from the market in their risk evaluation and planning.

Response to recommendation

This is welcomed. The probability that one of the remaining Big Four firms is lost is low because lessons were learnt from the Enron debacle. Moreover the stock market and the auditing profession have recovered well since the collapse of Andersen. However, consumer confidence was badly hit in the months immediately after these fiascos and the disappearance of another large firm would have an even greater impact on the market than the loss of Andersen (due to the lack of firms and relative sizes). I feel that regulators must put into place emergency provisions in the case of a lack of choice resulting from the loss of a Big Four firm.

References

- Akerlof, G. A., (1970). "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism". *Quarterly Journal of Economics* 84 (3), August: 488–500.
- McMeeking, K.P.; Pope, P, F and Peasnell, K. V. (2006). "The determinants of the UK Big Firms Premium", *Accounting and Business Research*, 36, 3, 207-231.