

Summary comments:

While we support the aims of the Audit Choice initiative by the FRC, our view is that any measures adopted will only be effective if there is a common international approach to the audit marketplace, or at the very least consistent EU and US approaches.

We also believe that any solution needs to balance the need for independent rigorous audits with the objective of more audit choice. Ironically regulations imposed over the past few years to enhance audit quality have had the effect of increasing the barriers to entry to new firms in joining the global audit marketplace and to increase the obstacles to switching auditors within that marketplace. The principal market restrictions arise from the scale and complexity now required of organisations that wish to compete for audits. Although there may be a case for increasing the financial resources available to firms that might want to enter this space (eg through access to capital markets) the principal issues relate to the need to obtain the scale and breadth of technical expertise necessary to act as an auditor of complex multinational businesses – something that has taken years for current firms to build. In addition the extremely high regulatory burden placed on audit firms (eg oversight by multiple regulators, the very different regulatory and legal frameworks in different jurisdictions) again requires scale and expertise to achieve compliance, and that a number of these regulations restrict audit choice by inhibiting switching.

The other area that needs to be considered is the cost of switching as the audit product is inherently “sticky” as changing auditors is a costly exercise in terms of both the financial investment required of bidding firms and in terms of the level of investment of management time required. This inevitably restricts the ability and willingness of businesses to change auditors and the willingness of non-Big 4 firms (with smaller resources) to compete with Big 4 firms for the audits of multinational companies. Hence our view that appropriate action to increase audit choice should consider the following potential thoughts:

- reducing the compliance burden to audit firms operating in multiple jurisdictions through a common international approach to audit standards and audit regulation;*
- increasing the ability to switch audit suppliers for both audit and non-services, by simplifying and standardising internationally the restrictions on the non-audit services provided by audit firms. For example a simple restriction based on a multiple of audit/audit-related fees, would be much easier to manage instead of the current plethora of complex (and different from jurisdiction to jurisdiction) independence rules;*
- improving the access of audit firms to scale and technical expertise by easing the practical restrictions on subcontracting (e.g. creating a framework for audit firms without the scale of the Big 4 to subcontract complex technical areas to other firms, including specialist non-audit firms that deals with the audit quality and inspection issues that arise without making such an arrangement prohibitively expensive)*
- reducing the risk of further reduction in audit choice by establishing international protocols and communication channels to deal with the failure of an audit firm – options that could be considered include some form of regulatory approved administration arrangement or transfer of an audit firm’s operations as a going concern as alternatives to break-up or dissolution.*

SUMMARY QUESTIONS

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

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

Response: *Yes, although we feel that one other criteria – **relevance** – needs to be considered. In particular, solutions that may be appropriate to smaller domestic UK companies may not be relevant to large complex multinational businesses.*

- B** 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?

Response: *Yes. Although it may not be easy to achieve, we believe that the formation of a supranational governing body, with common regulatory framework internationally, would enable non-Big 4 firms to compete more effectively with Big 4 firms. Application of, and compliance with, the regulations of such a governing body could also provide assurance to company boards and audit committees when selecting their audit firm.*

PROVISIONAL RECOMMENDATIONS

SUPPLY-RELATED 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.

1a Do you support the stated objective of the recommendation? *Yes. However, although access to capital markets or alternate sources of funding may assist enable other firms to compete more effectively with the Big 4, access to financial resources is not the only barrier. The task of building a firm with the scale and resources to operate effectively in the international audit marketplace requires the combination scale, geographic reach and expertise, and it is not just “investment funding” that is required to achieve such a platform.*

1b Do you agree with the assessment of the recommendation or if not, why not?

We agree with the assessment of the recommendation in principle. However, we do believe that any actions in this area must be adopted on an international basis, as it is in the area of international audit firm networks that the main competition issues exist.

1c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

Other ways that the ability of non-Big 4 to compete against the scale and expertise of the Big 4 are to reduce restrictions on their ability to access other expertise – for example common international audit regulation and methodologies would enable other firms to subcontract particular jurisdictions to local audit firms, or to access external expertise. For example, the Big 4 have significant in-house practices in their treasury, valuations, actuarial and specialist industry groupings that they can access for audit purposes that are not available as easily to non-Big 4 firms and which cannot be supported solely for audit purposes.

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

2a Do you support the stated objective of the recommendation?

In principle, we support this recommendation although we have some doubts as to whether this will have any practical impact in attracting competition – competitors to the Big 4 already have sufficient information on the economics of the audit business – it is their ability to achieve scale and expertise that prevents them accessing the market for large complex multinational audits.

2b Do you agree with the assessment of the recommendation or if not, why not?

Yes. However, the significant differences in audit firms' management structures, client base and internal charging arrangements that may make the provision of meaningful comparisons both costly and complex indicate that regulators should be cautious in imposing additional burdens on audit firms. It may also be counterproductive, as the Big 4 may be better placed to take advantage of such information to compete against smaller firms than vice versa.

2c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria? N/A

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

3a Do you support the stated objective of the recommendation? Yes

3b Do you agree with the assessment of the recommendation or if not, why not?

Yes. We concur that one of the overriding factors in the ability of firms to compete internationally is their ability to manage the risks imposed by liability arrangements in different countries and the ability of firms to mitigate those risks, for example through access to commercial insurance markets.

3c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

One potential area would be to permit audit firms to develop industry-wide insurance arrangements (eg insurance pools) as collectively they may be able to obtain better access to insurance and reinsurance markets, in particular for firm-threatening risks.

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

4a Do you support the stated objective of the recommendation? *In principle we support the stated objective, but we would support "active participation" rather than merely "encouraging participation". Partly this may be a matter of funding and time commitments - the Big 4 have the scale and profitability to support the release of highly remunerated partners to such activities away from profit-generating activities, whereas non-*

Big 4 firms do not have the scale to support such releases, in particular across multiple jurisdictions (ie it is not just seats on the ASB and APB that need to be filled, but also all their equivalents in other jurisdictions).

4b Do you agree with the assessment of the recommendation or if not, why not? *Yes, although the relevance of the ASB and APB are diminishing as responsibility transfers to the EU and global bodies, and perhaps it may be better to address representation on those bodies.*

4c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

Another possible solution to achieve active participation would be to make changes to the governance structures of the relevant regulatory bodies such that participation by non -Big four members was required. The quality of that active participation could be enhanced, if the non-big four firms could identify in a coherent manner an appropriate pool of talent from which the regulatory bodies could choose participating members.

DEMAND-RELATED RECOMMENDATIONS

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.

5a Do you support the stated objective of the recommendation? *Yes, we agree that the FRC should continue its efforts to promote understanding of audit quality and that transparency of reporting on audit inspections together with information relating to governance / policy issues within audit firms would compliment these efforts. While we see the primary responsibility for promoting the capability of a particular audit firm lies with that firm itself, we believe that the FRC can certainly add valuable additional and independent evidence to support confidence in audit firms.*

5b Do you agree with the assessment of the recommendation or if not, why not? *Yes, we agree with the Effectiveness and Quality assessments. However, we believe that there is a cost implication for all audit firms, particularly in the initial stages of providing comparable information on capabilities and audit inspections, that favours the Big 4 firms over smaller firms and may discourage smaller firms from competing in this market.*

5c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria? *There may be merit in promoting the capabilities of individual firms through the publication of an independently verified “scorecard” of each firm’s capabilities, covering such areas as global reach, audit quality, technical expertise etc. etc.*

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.

6a Do you support the stated objective of the recommendation? *Yes. In line with the some of published responses to the FRC's 2006 discussion paper, we would welcome greater explanation of the practical application of the suggested mechanisms. Further consideration should be given to those companies and audit firms working under the regulatory constraints of global markets, in particular the US market.*

6b Do you agree with the assessment of the recommendation or if not, why not? *We agree in most part with the assessment. However, we believe that it will take action by multiple regulatory bodies to achieve this objective. In the case of major public interest entities with geographic interests and/or listings outside of the EU, particularly in the US, there are significant hurdles to overcome, and international co-operation is vital.*

6c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria? *N/A*

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.

7a Do you support the stated objective of the recommendation? *We are not in favour of joint audit arrangements in that they either (or both) increase the risk of incorrect audit assessments (eg BCCI, Parmalat) or they increase costs as a consequence of requiring two audit firms to cover the same areas.*

However, we do believe that it is appropriate for a primary auditor to be able to subcontract audit procedures in particular jurisdictions (extending their scale and geographical reach) or in particular areas of technical expertise, provided that they retain full responsibility for the audit opinion on the consolidated financial statements. Hence we support the recommendation in the context of subcontract arrangements, and in particular actions to enable such arrangements to function practically, eg in the form of common audit standards and regulations, rights of access to the working papers by the primary auditor and by audit regulators, privilege protections on communications between different firms relating to confidential client matters. Although cost and efficiency consideration will always advantage a single supplier over multiple suppliers, current regulatory and risk considerations are the real market barrier in this area.

7b Do you agree with the assessment of the recommendation or if not, why not?

For the most part, we agree with the assessment and would welcome further investigation into the cost of management time and effort in dealing with more than one audit firm and the potential risk associated with varying audit methodologies.

7c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

We would welcome consideration being given to improving the ability of non-Big 4 firms to address the scale and technical expertise requirements that the need to compete. Perhaps through enabling 'partnerships' with Big 4 firms, or through the use of non-audit firms to provide technical expertise. Enablers would include common audit methodologies and international consistency in regulation over such arrangements.

RECOMMENDATIONS AIMED AT IMPROVING BOARDS' ACCOUNTABILITY FOR THEIR AUDITOR SELECTION DECISIONS

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.

8a Do you support the stated objective of the recommendation?

Yes. We welcome the conclusion that the primary responsibility for auditor selection should remain with the boards of companies.

8b Do you agree with the assessment of the recommendation or if not, why not?

Yes. We welcome further acknowledgement of the boards' responsibility in this area and the consideration given to the risk of incurring costs in respect of tendering for tendering sake.

8c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria? N/A

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

9a Do you support the stated objective of the recommendation? Yes

9b Do you agree with the assessment of the recommendation or if not, why not? Yes

9c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria? N/A

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.

10a Do you support the stated objective of the recommendation?

In line with representatives of the investor groups, we support the provision of information on the auditor selection process which we believe will increase shareholder awareness when they vote annually to appoint or re-appoint the auditor of a company.

10b Do you agree with the assessment of the recommendation or if not, why not?

Yes. We would welcome the provision of improved information on the auditor selection process to increase shareholder awareness.

10c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

As discussed above, we believe the improved of policy information would be less onerous than an additional auditor appointment vote.

RECOMMENDATIONS AIMED AT INCREASING THE POTENTIAL FOR SWITCHING BETWEEN BIG FOUR AUDIT FIRMS

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

11a Do you support the stated objective of the recommendation? Yes.

11b Do you agree with the assessment of the recommendation or if not, why not? *Yes. Independence considerations are significant barrier to choice of other Big 4 firms. Simplifying rules in this area (whether completely, or through allowing appropriate “transition” periods) would enable more firms to be able to compete for assignments requiring independence – at the moment the choice can be effectively be limited to one alternative firm only.*

11c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

Although there are some services (eg management services) that are incompatible with auditor independence, there are many others that are restricted by different regulators for similar reasons, but slightly different conclusions. We believe a much simpler, and most importantly, single international set of rules would improve access of companies to Big 4 firms.

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.

12a Do you support the stated objective of the recommendation? Yes

12b Do you agree with the assessment of the recommendation or if not, why not?

Yes. However, we recognise that there are other factors that limit auditor choice, particularly for large public interest entities subject to non-UK audit regulations, such as the desire not to share the same auditor as one’s competitors and the capability of audit firms to operate across many countries.

12c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria? N/A

RECOMMENDATIONS AIMED AT REDUCING THE RISK OF AN AUDIT FIRM LEAVING THE MARKET WITHOUT GOOD REASON

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

13a Do you support the stated objective of the recommendation? *Yes. However, while we recognise that this area is unlikely ever to be completely aligned internationally due to the inherently different legal frameworks and regulatory and judicial approaches, we consider that some form of coordinated international approach might be possible.*

13b Do you agree with the assessment of the recommendation or if not, why not? *Yes*

13c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

One approach might be to establish some form of administration or “Chapter 11” type arrangement which would allow a firm to continue, perhaps under regulatory supervision, while the “market-withdrawal issue” is addressed.

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.

14a Do you support the stated objective of the recommendation? *No. The primary purpose of the Combined Code on Corporate Governance is to protect the interests of shareholders, in the context of a joint stock company where management and ownership is divorced. While strong corporate governance is to be encouraged, we are not sure that implementation of rules designed to protect investors has any real bearing on the debate about consumer choice or customer protection.*

14b Do you agree with the assessment of the recommendation or if not, why not? *No.*

14c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

Existing audit regulations and professional ethical requirements already require audit firms to operate to high professional standards. In fact, regulatory inspections already mean that these are already much stronger than the Combined Code on Corporate Governance. If there is considered to be a gap in audit regulations then we recommend that this is addressed as part of the regulatory framework for audit firms rather than creating multiple regulatory frameworks for audit firms to follow.

Further, we believe that it would be beneficial to adopt a common international framework of regulation for audit firms, and again would consider that a UK only regulation would inhibit, rather than enhance, the ability of firms to operate in multiple jurisdictions.

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.

15a Do you support the stated objective of the recommendation? Yes

15b Do you agree with the assessment of the recommendation or if not, why not? Yes

15c What alternative recommendations could achieve the desired objective in a way that meets the assessment criteria?

Although clearly it is incumbent on all entities to consider the risk of such an eventually, we believe that it is more important that audit regulators internationally develop plans for an audit failure or withdrawal, in the same way that banking regulators now have established protocols and communication links to deal with banking failures.