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RESPONSE OF THE ASSOCIATION OF BRITISH INSURERS TO THE FINANCIAL REPORTING COUNCIL DISCUSSION PAPER ON CHOICE IN THE UK AUDIT MARKET

1. General Comments

1.1 The Association of British Insurers represents leading wholesale investors as well as preparers of accounts in an important and complex sector. Its members therefore have a strong interest in a flourishing audit industry, offering both choice and quality to the benefit of users and preparers of accounts alike.

1.2 We therefore welcome the leadership the FRC is showing in promoting the current discussion. Although many of the issues have an international dimension, it is only through such debate at national level that solutions will be found.

1.3 While we note that many of those surveyed in the recent Oxera research felt that the status quo with four large audit firms was one with which they could live, it was also clear that many would find the level of choice unacceptably narrow if the number of large firms were reduced to three.

1.4 We concur with that view and are particularly worried about the further damaging effect that the absence of competition would have on quality. The issue is not merely one of price. A serious concern is regulatory capture. We are not comfortable with a position where large firms could determine the shape of regulation by threatening to withdraw from the audit market

1.5 It is therefore sensible to examine ways of maintaining and increasing the choice in the audit market.

1.6 Such an objective cannot be realised overnight. It would be best achieved by a series of measures taken by a range of interested parties, including companies, investors, audit firms and regulators whose effect would be cumulative over time. Success would be measured, at least initially, by a gradual increase in the share of Tier A audit firms in the audit market for FTSE 250 companies.

1.7 Many relevant measures involve behavioural change, which may well not be susceptible to regulation. For example, companies should consider the need to rotate auditors more frequently and make sure they take all options into account when they do so. Investors need to make clear, as the ABI has recently done, that they do not automatically expect companies to select an auditor from among the Big Four.

1.8 It is important that ways are found to maintain momentum without resorting to prescriptive regulation. One possibility would be for the FRC to use the results of this consultation as the starting point for a consensus statement of principles on promoting competition and choice in the audit market against which achievements could be measured. Our specific responses below suggest a number of steps that could be taken to improve choice. We expect that other respondents will also have useful ideas which could be considered in compiling such a statement.

1.9 Such a market-based approach to audit competition and choice should be backed up by heightened vigilance on the on the part of the competition authorities at both EU and national level. It should be clear to the large accounting firms that, if their share of the market is deemed to be excessive, they will be obliged to divest part of their business.

1.10 Particularly focus should be given to the cross subsidisation of audit by non-audit services. There is a risk large firms who can afford such subsidisation will use this device to create a barrier to entry by smaller firms. While companies and shareholders are, rightly, concerned about being overcharged for poor quality audit services, it is simple common sense that a fair price for audit is a prerequisite for the maintenance of both choice and quality.

1.11 If the ability of the competition authorities to require divestment is to be credible, then there must be confidence that others in the market would be willing and able to take on the business that is divested.

1.12 It is therefore important to be sure that there are not constraints, one of which might be the availability of capital. It would be sensible to review whether there is a case for raising the scope for outside capital to be applied to the audit industry. European regulations currently prevent more than 49 per cent of any firm being owned by non-auditors.

1.13 This issue was not raised in the discussion paper, but we acknowledge it is a complex one. We believe it should be given careful and balanced consideration so that the market can be satisfied that access to capital is not a constraint to competition.

1.14 Because of the time it will take to develop greater and more viable choice in the audit market, we believe that the authorities at national and international level should have a contingency plan for addressing the consequences of a firm leaving the market, but we also believe the need for such a plan would diminish if the competition issues were addressed *before* rather than *after* another firm left the market.

1.15 We do not consider that a limit on the liability of auditors is the right way to proceed because a limit on liability provides no incentive to quality and may indeed encourage auditors to cut corners and take risks. On the other hand we are aware of no evidence that this will add to choice by encouraging additional entrants to the market.

2. Specific responses

1. *Do you agree that the focus of the debate should be on the degree of choice in the market for audit services to large public companies, rather than other features of this market?*

   The degree of choice is a key issue because, with insufficient choice, there is little impetus for quality. Although the Oxera report argued that lack of choice was tending to drive up the cost of audit, investors are less concerned about this aspect of concentration. Their main concern is with quality and reliability. Within reason, they recognise that quality has to be paid for. Indeed a fair price is a prerequisite for both quality and choice.

   A far greater risk to quality, if choice is limited, arises from the possibility that the regulatory authorities will become subject to capture by the few remaining providers. We are not comfortable with a position where the largest providers of audit services can resist appropriate regulation by threatening to withdraw from the market. The more this position exists, the greater the need for action by the competition authorities.

   A significant impact on choice also comes from the conflicts of interest arising from the provision of non-audit work. We do not believe it is practical to prevent auditors undertaking non-audit work. Instead we have always supported a governance approach whereby the audit committee should demonstrate that it takes account of conflicts in letting such work so as to ensure that the auditor remains independent.

   As a practical measure we believe that non-audit work should be spread widely through the market and investors should be vigilant in ensuring that audit committees have proper tendering processes which do not compromise the independence of their audit.

2. *What do you regard as the most important criteria for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market?*

   There is no single step that could be taken to enhance choice in the market. The only solution is likely to be a series of incremental measures taken by different parties: regulators, auditors, audit clients and shareholders. In principle we favour market-based solutions wherever possible, but the key criterion for evaluating any step is likely to be its contribution to easing the problem of concentration. A collection of small steps will provide a cumulative benefit over time.

   The threat of action by the competition authorities would, however, provide a strong incentive to the development of choice. Audit firms should be in no doubt that the level of competition in the market is being actively monitored by the authorities in both the UK and EU and that the authorities would require those with an excessive market share to divest a portion of their business.

   The monitoring should have particular regard to the ability of larger firms to cross subsidise audit with non-audit services. We have long been concerned that the largest firms may use their clout to cross subsidise audits through the provision of non-audit services at high prices. As they can afford to do this, this activity can entrench their position in the market. In extreme cases it may compromise their independence.

   Another area, which would merit competition authority attention, is covenants in loan contracts. A loan covenant that requires a company to have a Big Four auditor may have the effect of limiting competition, even if it is not intended to do so.

   We also believe that regulators could help by ensuring that their policies are not tilted towards the business model of the large firms. This means recognising the role of medium-sized firms and consciously engaging them in the regulatory debate. The greater the risk of regulatory capture, the more consciously it must be fought.

3. *We invite views on how different groups, acting individually or collectively, could increase the propensity of non-Big Four firms or new firms to seek to be major players in the market for audits of large companies.*

   As already stated we believe that there is no quick fix, but the issue of concentration needs to be addressed by a series of behavioural changes by all involved, which will gradually lead to an increase in choice. We confine our specific response to contributions from the corporate sector (reflecting our interest in governance), investors and the regulator.

We believe that companies have an important role to play as they initiate the selection of auditor which is subsequently approved by investors. We do not support mandatory rotation as this would create a culture of bureaucratic compliance, but we were struck by the evidence on the Oxera Report about how rarely companies replace their auditors in practice.

Companies should keep their choice of auditor under regular review and periodically tender for new auditors. When they do so they should be transparent about the criteria they are using and the process must be the clear responsibility of a properly constituted audit committee. The choice of auditor should not be made by the management and then ratified by the audit committee.

Quality should be a more important consideration than price. Too many auditors in the past have been effectively chosen by finance directors anxious to make a virtue out of their ability to drive down costs. This cannot have been positive either for quality or for overall choice in the market.

Large companies may also help by ensuring that they do not compromise their choice of auditor unnecessarily through their approach to commissioning non-audit consulting work. The ABI has never favoured banning auditors from doing consultancy work, but companies whose choice of auditor is limited should not compound the problem by letting non-audit work to a firm which may in practice be their only alternative auditor.

Investors can, meanwhile, help by making it clear that they do not necessarily object to the selection of an auditor from outside the Big Four. The ABI has recently issued a statement clarifying this after it became clear from the Oxera Report that audit committees are tending to second-guess the views of investors and are too pessimistic about investors' likely reactions to a choice outside the top-tier. We made it clear in the statement that investors are willing to engage with audit committees on the question of audit choice. This may help alleviate doubts about their likely reaction.

A first step towards engagement is for companies to communicate their thinking clearly in their audit committee reports. We believe more generally that there is room for more discursive reporting by audit committees about judgements that have been made in the preparation of the accounts, about steps taken to ensure that non-audit consultancy work does not compromise the independence of auditors and about their approach to hiring auditors, Again this is a matter for behavioural change. There has been discussion about the possibility of a vote on the audit committee report as a means of prompting greater engagement between audit committees and investors, but there is already a vote on the appointment of auditors and it may not be necessary to duplicate this. For the time being, we feel that companies could provide investors with more information which will make the vote on auditor appointments a more considered one.

As to the regulators, it is important that they take conscious steps to ward against regulatory capture. Also they should be alert to the need to identify barriers to entry.

Specifically, they should satisfy themselves that constraints on the use of outside capital do not operate in this way. Lifting the current limit might enhance the possibility for mid-tier firms to develop more rapidly. It might also help address problems that would arise if a large accounting firm left the market.

We are aware that there are counter arguments. For example, scope to raise additional capital could be used to further entrench the position of large firms. Or it might encourage business models with inadequate focus on quality. We are also not sure how much extra capital might flow into the sector if the constraints were lifted.

It would therefore be wrong to prejudge the outcome of any review. Its purpose would be to ensure that access to capital was not acting as a barrier to entry.

4. *We invite views on how the propensity of companies and their audit committees to purchase audit services from non-Big Four firms could be increased.*

   See our answer to question 3.

5. *We invite views on the combination of steps that would be most likely to lead to increased choice, whether these steps could be taken forward by market participants, or whether existing laws and regulations may constrain or prevent this, and on the costs of the steps relative to the risks arising from the existing or potential degree of concentration in the market.*

   As already stated, we believe that a combination of small steps by all involved is most likely to lead over time to the development of choice. Most involve behavioural change, which is not subject to regulatory intervention.

It is therefore important to maintain momentum. One possibility would be for the Financial Reporting Council to draw on the results of this consultation to prepare a consensus statement of principles on the promotion of competition and choice in the audit market, against which performance and progress could be measured.

6. *We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market.*

   Audit firms can protect themselves by ensuring that the work they produce is of high quality and that they protect themselves against unnecessary risk. Andersen's withdrawal came about as a result of loss of confidence among its clients following some elementary internal breaches of sound practice, including over-reliance of the Houston office on one audit account.

   Two lessons can be drawn from this. The first is that the culture of large firms should be such that any particular aberration is seen as an exception rather than evidence that the whole firm is contaminated. The second, which follows from the first, is that audit firms should have proper internal controls which protect them against unnecessary risk and enable them to demonstrate that their culture is sound, that they do not run excessive risk and condone low standards of professional practice.

   The discussion paper appears to suggest that there is a possible role for companies and investors in responding with restraint to new information about potential problems faced by a large audit firm. It is not, however, up to client companies or their shareholders to rescue auditors by remaining with them at a point when confidence has evaporated.

   If a major audit company is in serious difficulty, there will not normally be time for its clients to discuss with their own shareholders whether to continue to support it. The Andersen collapse was on a global scale because its breach of best practice was so serious that loss of confidence was general.

   In effect, the consequence was like a run on a bank. It is difficult to conceive of institutional arrangements that would enable companies and their shareholders to continue to support the existence of an auditor in this type of predicament and thereby stave off such a "run" in future.

   It is far better if audit firms are organised so that confidence in the entire organisation does not evaporate because of one particular lapse. Internal controls are key.

7. *We invite views on steps that could be taken to mitigate the effects of a voluntary or involuntary withdrawal of a firm from the audit market*

   Since the risks of concentration are likely to remain for some time, we believe the regulatory authorities should develop a contingency plan. Whether the market should know of the existence and nature of such a plan is moot. Moral hazard considerations must be weighed up against the expectations of large audit firms that they will be protected by special regulatory treatment because they are too important to fail.

   The latter problem and the need for such a plan would diminish if the competition issues were addressed now, rather than after there is another failure. Indeed one test regulators could apply in judging the need for competition authority intervention is whether they already feel constrained in disciplining one of the Big Four for serious breach of standards.

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