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3 August 2006

Dear Sir

DISCUSSION PAPER: CHOICE IN THE UK AUDIT MARKET

We are pleased to respond to the Financial Reporting Council's discussion paper on choice in the UK Audit Market.

This is an important issue and we value the work of the FRC in progressing the debate. You will not be surprised to learn that our response contains no easy answers. However, it highlights four key messages which we believe are paramount.

1. Quality is key

The provision of trustworthy information to investors and other stakeholders is critical. Audit firms play a key role in this. Choice in the audit market is important in ensuring that companies have access to audit firms that deliver quality work. However, it should not be pursued at the expense of high quality. The impact on quality of any potential mechanism to increase the level of choice should be rigorously tested.

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2. Preventing any further reduction in the number of large audit firms should be a priority in the short term

There are no quick fixes available to increase choice in the market for auditing large companies. However, the threat remains of a further reduction of choice, either by the collapse of one of the Big Four and/or the voluntary withdrawal of a firm. To the extent that there are concerns about the level of choice in the market, therefore, the most important priority should be to prevent this. There are two specific areas of the Company Law Reform Bill which, depending on their outcome, could help to address this:

- adopting a regime of proportionate liability for audit firms; and
- ensuring that auditors are not subject to the risk of being tried for a criminal offence as a result of honest mistakes.

3. Non-Big Four Firms will need to invest to compete for large audits

The current level of concentration in the audit market has evolved as a result of many years of sustained investment by the Big Four and their antecedent firms. This has enabled them to satisfy the purchasing criteria of large companies much better than smaller firms. Smaller firms will need to invest to compete.

Priorities for non-Big Four firms wanting to compete are:

- focus on growth, both in terms of absolute size and international coverage. This could be achieved through a combination of two or more firms and/or organic growth;
- identify the specific industry sectors in which to compete;
- invest in attracting and retaining highly skilled resources; and
- invest in managing risk, particularly those associated with regulation.

4. The role of regulators is critical

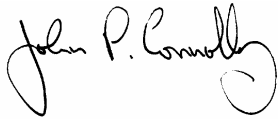
Firms will only be interested in competing in the audit market if it remains attractive: there must be reasonable prospects that firms will be profitable, secure and capable of offering fulfilling careers to current and potential employees. Regulators play an important role in determining this. Choice is most likely to be promoted in a regulatory environment that is proportionate. We are fortunate that the FRC is pursuing such an approach. Given the global nature of auditing, the actions of UK regulators alone are insufficient. Regulators around the world,

particularly in the US, should adopt a coordinated and measured approach to audit regulation to build a strong, secure sector.

An important priority should be the promotion of a principles-based approach to accounting, reporting and auditing. At present, the ability of a firm to carry out audits is highly dependent on having the technical resources to understand the rules and provide guidance on them. Inevitably, this means that large audits gravitate to those firms who invest most in such resources. Moving towards a more principles-based approach would enhance the ability of non-Big Four firms to compete.

We look forward to continuing to participate in this important piece of work. If you have any specific questions about our response, please don't hesitate to contact Martyn Jones or Gerry Paisley.

Yours faithfully

A handwritten signature in black ink that reads "John P. Connolly". The signature is written in a cursive style with a large, stylized initial 'J' and a circular flourish at the end.

John Connolly

Financial Reporting Council

**Response to Discussion Paper: Choice in the UK
Audit Market**

August 2006

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1 Introduction

This paper sets out Deloitte's response to the Financial Reporting Council's discussion paper of May 2006 entitled "Choice in the UK Audit Market". We recognise that this is a complex and important issue and value the work of the FRC in progressing the debate.

The discussion paper contains a number of specific questions. Given the complexity and importance of the issue, we summarise our comments on the subject before addressing each question. As a result, Section 2 of this paper sets out an overview of our position. Our responses to the individual questions are shown in Section 3.

2 Overview

Quality is key

The provision of trustworthy information to investors and other stakeholders is critical to the success of capital markets. Audit firms play a key role in this. They must deliver consistently high quality work to ensure a sustainable future for themselves and, more widely, for the markets in which they operate.

Choice in the audit market is important in ensuring that companies have access to firms that deliver quality work. However, delivering greater choice without a focus on quality could lead to a loss of confidence in capital markets. Consequently, the impact on quality of any potential mechanism to increase the level of choice should be rigorously tested.

Preventing any further reduction in the number of large audit firms should be a priority in the short term

There is no burning platform for significant change in UK audit market: confidence among stakeholders is high and has improved significantly over the last four years, as shown below (source: Ipsos MORI poll in April 2006, reported on page 24 of the FRC’s 2005/6 Annual Report).

Confidence in Auditing of UK Companies

	2006: <i>Very confident</i> (%)	2006: <i>Fairly confident</i> (%)	2005: <i>Very confident</i> (%)	2005: <i>Fairly confident</i> (%)	<i>Increased confidence over last 4 years</i> (%)	<i>Confidence stayed the same over the last 4 years</i> (%)
<i>Directors</i>	41	53	37	50	44	42
<i>Investors</i>	20	66	20	70	36	42
<i>Auditors</i>	38	58	n/a	n/a	60	38

In addition, non-Big Four firms are competitive for many types of company. Companies listed on AIM are more likely to hire non-Big Four auditors than those listed on the London Stock Exchange’s Main Market (because their purchasing criteria are different from those of larger companies – for example, they typically have less need for international coverage). AIM has thrived in recent years: since 1997 the number of companies listed on the Main Market has fallen by about a third while the number of companies listed on AIM has doubled.

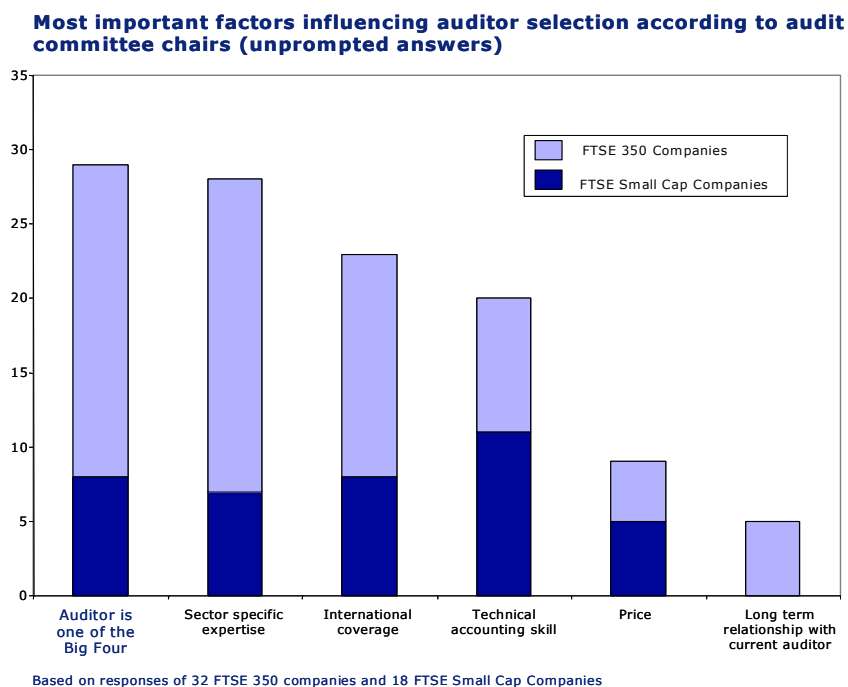
Nevertheless, there would be significant upheaval – both among companies who are audited and in the audit profession itself – if one of the Big Four were to collapse. Despite their size, the security any of the Big Four is not guaranteed: the experience of Andersen in 2002 demonstrates how fragile an audit firm can be.

To the extent that there are concerns around the level of choice in the UK audit market, therefore, the most important priority in the short term is to ensure that there is no further reduction in the number of large audit firms. There are two specific areas in the Company Law Reform Bill which, depending on their resolution, could help to address this:

- adopting a regime of proportionate liability for audit firms will reduce the likelihood of a collapse of an audit firm, while ensuring that they retain responsibility for their own actions; and
- auditors should not be subject to the risk of being tried for a criminal offence for making honest mistakes. This will reduce the attractiveness of the auditing profession to some of the most able practitioners and impose significant costs on clients.

Non-Big Four firms will need to invest to compete for large audits

The current level of concentration in the audit market has evolved as a result of sustained investment by the Big Four and their antecedent firms over many years. This has enabled these firms to satisfy the purchasing criteria of audit committees in large companies (including technical accounting skills, reputation with investors, sector-specific skills and an international network) much better than smaller firms. As a result, whether an audit firm is a member of the Big Four is the most important single factor cited by audit committee chairs in influencing their selection of an audit firm, as shown below (source: Oxera report, Figure 3.3).



No short term fix is available to non-Big Four firms to raise their performance on audit committees' most important purchasing criteria. They will need to invest over a period of many years.

Key priorities for non-Big Four firms wanting to compete are:

- grow significantly, both in terms of absolute size and international coverage. This could be achieved through the combination of two or more firms and/or organic growth. In addition, increasing the scale of non-audit services will help to provide the coverage, human resources, financial muscle and credibility required to win more large audits;
- identify the specific industry sectors in which to compete;
- invest in attracting and retaining highly skilled resources; and
- invest in managing risks, particularly those associated with regulation.

The role of regulators is critical

Big Four and non-Big Four firms will be interested in competing for audits only if the market is attractive. There must be reasonable prospects that firms will be profitable, secure and capable of offering fulfilling careers to current and potential employees. Regulators play an important role in determining this.

In the UK we have been fortunate that the FRC and its constituent organisations have adopted a consultative, collaborative and even-handed approach to promote high quality throughout the audit profession.

Going forward, choice is most likely to be promoted in a regulatory environment that is proportionate, both in the UK and abroad. Regulators around the world, particularly in the US, should adopt a coordinated and measured approach to audit regulation to build a strong, secure audit sector, resisting prosecution of an entire firm to punish the actions of a few, and encouraging able people to build their careers in the auditing profession.

An important priority should be to promote a principles-based approach to accounting, reporting and auditing rather than a complex rules-based approach. At present, the ability of a firm to carry out an audit is highly dependent on having the technical resources to understand the rules and provide guidance on them. Inevitably, this means that large audits gravitate towards those firms who invest most in such resources: the Big Four. A more principles-based approach would place greater reliance on the judgement of individual auditors and help to level the playing field. Therefore, by promoting principles rather than rules, regulators would help to reduce the power of the Big Four and enhance the ability of smaller firms to compete.

3 Responses to Questions

3.1 Question 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?

As set out in the Section 2, choice in the market for audit services is important to the extent that it ensures that current and potential clients have access to audit firms that deliver high quality work. It is critical, therefore, that in the pursuit of greater choice:

- the existing quality of work carried out by audit firms is not put at risk;
- the reputation for quality across the profession is maintained or enhanced; and
- further enhancement of quality is encouraged.

Point 14 of the consultation document states that “a restricted degree of choice might also be expected to represent a risk to high quality and competitive prices in the market”. This inference lies at the heart of much of the criticism of Oxera’s otherwise high quality piece of research. Analysis of the audit market shows it is incorrect.

- The research in the FRC’s own annual report and referenced in section 2 shows that stakeholders think that the quality of audits in the UK has increased significantly over the last four years, when the concentration of the market increased.
- Oxera’s own analysis showed that audit fees as a percentage of client turnover have decreased since 1995 while market concentration has increased significantly (Figures 4.2 and 5.2 of the Oxera report).

3.2 Question 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?

We understand that this question is around how initiatives to achieve the following could be evaluated:

- promoting increased choice, such that there would be more audit firms participating in the market for audit of large public companies;
- reducing the risk of an existing firm leaving the market; and
- reducing the costs of uncertainty and disruption in the event of a firm leaving the market.

In all cases, the overall criteria that could be used include:

- quality, ie the extent to which the proposed change would affect the quality of audits and the resulting confidence in capital markets;
- the practicality and desirability of the solution, including any disruption it would cause to companies, audit firms and other stakeholders;
- the long-term and short-term costs to companies and audit firms;
- the impact on the attractiveness of the audit sector, including the potential profitability of audit firms, the long term security of audit firms and their ability to offer fulfilling careers to current and potential employees;
- the cost of any additional new regulations that would be required, evaluated against the benefits; and
- the permanence of the resulting change.

3.3 Question 3

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

- *Non-Big Four firms: how firms could successfully identify and enter particular segments of this market*
- *Big Four firms; how the actions of one or more existing firms could improve the prospects for a non-Big Four firm or a new entrant*
- *Companies and their audit committees: whether the criteria used for selecting auditors, and for considering the effectiveness of their current auditors, could be more explicit*
- *Investors: how investors preferences for auditors could be clearer*
- *Lawyers, investment bankers and other advisers: how advisers' preferences for auditors could be clearer*
- *Legislators and regulators: how existing laws and regulations could be modified to increase the opportunity for participation by more firms*

Non-Big Four firms will be interested in competing for the audits of large companies only if the market is attractive. As set out in section 2 above, regulators in the UK and overseas should help to promote this by taking an even-handed, proportionate approach to audit regulation. They should encourage the most able people to build their careers in the profession and resist indicting an entire firm to punish the actions of a few. In the short term, there are two particular opportunities or challenges in the Company Law Reform Bill to make the market more attractive, namely the adoption of proportionate liability for audit firms and ensuring that auditors cannot be held liable for a criminal offence for making an honest mistake.

Assuming that the market for auditing large companies remains attractive, audit firms will be engaged based on their ability to satisfy the audit committee's purchasing criteria – including factors such as technical accounting skills, sector specific skills and international coverage. The Big Four tend to be engaged much more frequently than non-Big Four firms because they have invested over many years to build strengths in these areas. Assuming that the purchasing criteria of the audit committees of large companies do not change significantly, non-Big Four firms will also need to invest to compete effectively. This will take time: there is no quick fix. However, there are two possible activities that could be undertaken to optimise the benefits of investment.

- The FRC could study the audit purchasing process in large companies and track the relative importance of purchasing criteria over time. This could be segmented by, for example, company size, industry and the extent to which the company operates in overseas markets. This information, published on a regular basis (every two years, say), would help audit firms to formulate their investment plans.
- In parallel, the FRC could review the investment plans of non-Big Four firms on a regular basis to ensure they are targeted appropriately.

In addition, moves towards a more principles-based approach to accounting, auditing and financial reporting will help non-Big Four firms compete more effectively against the Big Four.

3.4 Question 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 by:

- *All firms: for example, how firms could provide further information to audit committees to facilitate comparisons across different types of firms*
- *Non-Big Four or new firms: for example, how the firms seeking to supply audit services to this market could better demonstrate their capabilities*
- *Big Four Firms: for example, how these firms could make any change of auditor less costly or risky to the company and its new auditor*
- *Companies and their audit committees: for example, how companies could develop working relationships with a wider range of audit firms to help them evaluate tenders*
- *Investors: for example, how investors could support audit committees in evaluating auditors and in selecting from a wide range of audit firms*
- *Lawyers, investment bankers and other advisers: for example, how advisers could support audit committees in evaluating auditors*
- *Legislators and regulators: for example, how existing laws and regulations could be modified in order to make auditor changes less costly or risky*
- *Other stakeholder groups*

As we noted in our response to Question 3, the stakeholders most able to cause a change in purchasing patterns are audit committees of large companies and non-Big Four firms. By exploring the audit purchasing process on a regular basis it might be possible to understand better the roles of other stakeholders and the ways in which they might be able to influence the choice of auditor.

We note that the POB is considering more transparent reporting on audit quality monitoring and that this is the subject of a separate consultation by the FRC. Clearly, greater transparency of audit quality monitoring could increase the propensity of audit committees to purchase audit services from non-Big Four firms, as long as non-Big Four firms could consistently demonstrate that they carry out high quality work. We plan to respond to this consultation document in more detail in due course.

3.5 Question 5

We invite views on:

- *The combination of steps that would most likely 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*
- *The costs of the steps relative to the risks arising from the existing or potential degree of concentration in the market*

Two conditions are required to increase choice.

- The market needs to be sufficiently attractive to encourage participants to compete.
- Competing audit firms must have the ability to satisfy the purchasing criteria of companies' audit committees.

We have expanded on both these points in our responses to previous questions, but would emphasise that the actions of UK regulators on their own will be insufficient. Regulators around the world, particularly in the US, need to adopt a coordinated and proportionate perspective. They should encourage high quality auditing whilst helping to ensure the profession remains attractive for current and future participants. As set out in section 2, we are fortunate that the FRC and its constituent organisations have been appropriate. It would be helpful if there was more evidence that a similar approach was being adopted by other regulators elsewhere in the world.

In the short-term, there are two specific areas in the Company Law Reform Bill which, depending on their resolution, could improve the audit market:

- adopting a regime of proportionate liability for audit firms will reduce the likelihood of a collapse of an audit firm, while ensuring that they retain responsibility for their own actions; and
- auditors should not be subject to the risk of being tried for a criminal offence for making honest mistakes. This will reduce the attractiveness of the auditing profession to some of the most able practitioners and impose significant costs on clients.

In the longer term, regulators around the world should resist indicting an entire firm to punish the actions of a few and encourage the most able people to build their careers in the audit profession. The costs of providing a proportionate regulatory regime should not be onerous. The better regulatory systems are based on principles promoting high standards rather than those based on detailed rules which are often too heavy-handed, expensive and relatively ineffective.

Moves towards a more principles-based approach to accounting, auditing and financial reporting will also be important in helping non-Big Four firms to compete more effectively against the largest firms.

3.6 Question 6

We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market, including steps by:

- *Big Four firms: for example, how the arrangements by which the firms assess and mitigate the risks that they face within their own markets and across their international networks could be more effective*
- *Companies and their audit committees: for example, how they ensure that their response to new information about potential problems faced by a large audit firm is well-informed and well-timed*
- *Investors: for example, how investors can support companies and their audit committees in responding to new information about potential problems faced by audit firms*
- *Lawyers, investment bankers and other advisers: for example, how advisers could support companies and their audit committees in responding to new information about potential problems faced by audit firms*
- *Legislators and regulators: for example, how regulators could facilitate the effectiveness of the arrangements by which information about potential problems faced by audit firms is handled in the markets*
- *Other stakeholder groups*

As set out in our answer to Question 5, the best way to mitigate the risk of an unnecessary withdrawal of a firm from the market is through operating a proportionate regulatory regime, based on principles rather than rules.

3.7 Question 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, including steps by:

- *Audit firms: for example, how the arrangements by which the remaining firms would respond to the loss of an audit firm could be more effective*
- *Companies and their audit committees: for example, how to increase the effectiveness of the arrangements by which companies that were previously audited by the failed firm would find a new auditor*
- *Investors: for example, how investors could support companies and their audit committees in responding to the loss of an audit firm*
- *Lawyers, investment bankers and other advisers: for example, how advisers could support companies and their audit committees in responding to the loss of an audit firm*
- *Legislators and regulators: for example, how regulatory requirements in the scenario of the loss of an audit firm could be modified so as to reduce uncertainty and disruption to the markets*
- *Other stakeholder groups*

Losing a large audit firm would create significant issues.

- Some companies may not be able to get their financial statements audited. The directors of these companies could then be in breach of their obligations under company law.
- There may be a general loss of confidence in capital markets.
- The audit market would be seen as being much less attractive. Some of the remaining large firms may decide to dis-engage potentially risky clients. Existing and future employees would be deterred from continuing or entering in the profession.
- Managing the resulting upheaval would create significant costs for audit firms and their clients.

It is unacceptable for a large firm to be deemed too important to fail. Nevertheless, regulators should make every effort to ensure that a large firm is not pushed into a voluntary or involuntary market exit, except in the most egregious circumstances. In particular, they should resist prosecuting an entire firm to punish the actions of a few, except in the most extreme circumstances.

The specific circumstances of a firm's exit would determine the best strategies to mitigate further damage. Regulators could take the lead, or play a prominent role, in encouraging audit clients, remaining firms and any other relevant parties to take a pragmatic approach to working through the difficulties.