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Our Ref: MJC

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Dear Mr Rose

DISCUSSION PAPER: CHOICE IN THE UK AUDIT MARKET

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to respond to the FRC's discussion paper titled Choice in the UK Audit Market.

Introduction

Grant Thornton is the largest financial advisory/accountancy firm outside the Big 4 in the UK. Our core audit market is small and medium sized public companies and independently owned private entities/firms. Grant Thornton is a market leader in its chosen audit markets of the Alternative Investment Market (AIM) and for private companies with turnover less than £500m. We are the UK member of Grant Thornton International, one of the world's leading international organisations of independently owned and managed accounting and consulting firms, which operates in 112 countries and employs over 22,000 people worldwide.

We have been actively involved in the FRC's research into and discussions on competition and choice in the audit market. We welcome this formal consultation, and share the FRC's commitment to improve competition and choice in the UK public company audit market.

Grant Thornton is enthusiastic about maintaining its leadership within AIM and significantly increasing its presence within the Full List.

Executive summary of our recommendations

- Enhancing competition and choice in the audit market is a long-term issue and there are no quick fixes. We are in favour of market-led solutions to address the problem of choice, which are more likely to work than direct intervention from regulatory bodies (such as breaking up one or more of the Big 4 firms).

The public company audit market is tiered and a solution lies beyond the upper tier of the market. It is among approximately 1,200 Full List companies, below the largest 150 or so, where the most significant problem lies with competition in the

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audit market. The vast majority of these 1,200 companies are well within the reach and skills set of a larger number of audit firms but this market segment remains dominated by the Big 4. Addressing this tier might provide a platform in the future from which the Big 4 dominance amongst the very largest companies might be challenged. Effective actions by key stakeholders can bring about significant improvements in the short to medium term.

- There are many stakeholders (from preparers, auditors, users, share owners and regulators) who have a role to play in the development of this debate. It is share owners' views which should be given greatest prominence.
- We welcome the public pronouncement on 14 June 2006 from the Investment Affairs Committee of the Association of British Insurers (ABI) which encouraged Full List companies to improve the range of choice. We urge other large investors to follow suit in making their views publicly known on a sustained basis.

We would encourage the FRC to speak to investor groups more regularly. The UK could lead the way by providing the market with a mechanism for dialogue between regulators and investors to discuss investor needs, building on the work of the Audit Quality Forum. We also believe the FRC could demonstrate global leadership by engaging with international investor bodies such as the International Corporate Governance Network (ICGN) which has expressed investor concerns on issues such as competition and choice and corporate governance.

- Audit firms should communicate their capabilities more effectively to the market and be specific about which market segments they choose to operate in. It is for organisations such as Grant Thornton International to boost their levels of brand awareness and international reach among their target audience.
- Greater transparency of the results of audit inspections would help dismantle some of the false perceptions identified in Oxera's report. Furthermore, greater detail about how conclusions of independent audit inspections are reached (and potentially publishing the conclusions) would provide better information to those responsible for audit appointments about the audit quality of firms.
- The FRC (in consultation with the DTI) has a key role to play in providing guidance to ensure proportionate liability is the form of liability that emerges from the passage of the Company Law Reform Bill. This measure has the broad support of all key stakeholders and over time is likely to provide an environment which encourages greater choice. We would encourage UK regulators to push for appropriate liability reform throughout the EU.
- It is in the interests of the FRC to maintain the momentum of the debate. By taking action to improve the market's understanding and awareness of the issue of choice and by promoting greater dialogue between investors and audit firms, the FRC can play a critical role in overcoming the structural deficiencies of the audit market.

- In developing new audit rules, standard setters should ensure that they involve, and are seen to involve, members of the profession from non Big 4 firms in the process and to take note of their views. The views from a cross-section of firms are likely to serve the needs of the entire profession and its clients more effectively.

Key assertions / principles in considering the audit market place and choice

Our starting point is the strongly held belief that increasing competition and choice in the UK audit market must be aligned with the concurrent aim of improving audit quality. We contend that effective measures to increase choice will also improve audit quality over time because companies would gravitate towards audit firms of the appropriate size and experience.

Secondly, Oxera's report 'Competition and choice in the UK audit market' demonstrated there is a structural problem with choice in the market place as it stands. All interviewees, with the exception of one Big 4 firm, felt the market would be improved by greater choice. One third of audit committee chairs interviewed by Oxera considered that the choice of auditor for their company was not great enough. Moreover, many share owners and audit committees were alarmed at the vulnerability of the UK capital markets due to this lack of choice.

Thirdly, many companies have been discouraged from changing auditor out of fear of an adverse reaction from investors. We have seen many examples of a company which has been dissatisfied with its incumbent auditor and was actively considering alternatives but which then opted to remain with the status quo because of perceived investor reactions.

Next, the key findings of the Oxera report suggested that the crux of the problem was that firms' reputations and investor attitudes were based on perception rather than fact. The FRC should focus on raising awareness to address this problem. Moreover, the Oxera report concluded that many public companies' buying criteria (eg. access to non-audit services, and 'insurance' concerns of audit committee chairs) did not further the interests of share owners; we believe the FRC should pay the greatest regard to share owners' needs ahead of those of other stakeholders.

Finally, we do not believe there is a systemic gap in audit quality between the Big 4 and some of the other leading audit firms. The Audit Inspection Unit's (AIU) report concluded that many of the issues identified in the first year inspections of what it describes as 'Other Significant' firms were of a similar nature to those reported last year in relation to the first inspections of the Big 4.

Analysis of the public company audit market

The public company audit market is tiered. There is a need to improve awareness of the current structure of the market and the audit firms which serve the different tiers. There might be as few as 150 UK companies whose audits require either such scale of resources (some but not all of the FTSE 100) or such highly specialised resources (large banks and insurance companies) that they are best served by a Big 4 firm, whose business model focuses on the scale of resources required by these multinational giants.

However, an institutionalised prejudice exists in favour of the Big 4 and runs much deeper across another 1,200 or so Full List companies. There is a handful of firms outside the Big 4, such as Grant Thornton, which have the audit quality, skills, reach and depth to audit the remaining quoted companies, most of which have more in common with companies on AIM, a market where Grant Thornton is the leading auditor, than with the 150 largest, most complex businesses, where market capitalisations can reach over £125bn and audit fees over £40m.

This prejudice is compounded by a lack of awareness in the market about "right-sizing", i.e. selecting the right size and type of audit firm: too small and the firm will not necessarily be sufficiently resourced or robust in its procedures; whereas too large and the firm will not necessarily pay sufficient attention to audit quality and high levels of service for its smaller clients.

It is firms such as Grant Thornton, however, which provide the most likely solution to the structural problem of choice, but proposed solutions will need to make clear what the advantages would be for such firms in augmenting their investment in this market.

Key actions by investors (share owners)

It is the views of the investor community which are the most important to this consultation. As end users of financial reports, their input is of great importance. They can inject impetus to the debate by providing comfort to audit committee chairs that it is 'safe' to appoint a non-Big 4 auditor.

The statement from the ABI (see Appendix B) to this effect is a very welcome milestone, but alone it is not sufficient. We urge other investors to make their views known. Investor groups should begin to challenge publicly the audit appointments of large listed companies, as such 'activism' can shape the future direction of the debate. The recommendation from Governance for Owners that large listed companies should disclose their contingency plans for appointing a successor auditor are to be welcomed if this signals a culture change in the attitudes and behaviour of investors.

Key actions by audit firms

The Oxera report found that leading audit firms outside the Big 4 need to communicate their capabilities more effectively to the market and to be more specific about their ambitions in their target markets.

We recognise that there are approximately 150 UK companies whose audits are best suited to the Big 4, but we question the unnecessary domination of the Big 4 of the remaining Full List companies. From a technical perspective, Grant Thornton, as the leading auditor on AIM, is able to audit most companies on the Full List. It is our responsibility to demonstrate our capabilities, namely a global audit approach, the technical know how to implement current domestic standards and IFRSs, sector specialisms, a methodology and commitment to quality assurance, coupled with a willingness to engage in positions of influence.

As a firm, Grant Thornton is determined to be more visible and to reach out to the UK and international investor community.

Key actions by regulators (audit inspections)

The Oxera report ascertained that audit committees found it difficult to assess audit quality. The FRC has a crucial role to play in redressing this problem. While acknowledging that the US situation is not perfect, the Public Company Accounting Oversight Board (PCAOB) has provided clear markers and set a good precedent for the UK in this respect. For example, Kayla Gillan of the PCAOB commented:

"I urge Audit Committees to challenge the assumption that every company must use a Big 4 firm, or risk being perceived as somehow of lesser worth. Even if a company is very large, with a very complex financial structure and decentralized operations, I suggest that the Audit Committee should also consider the so-called "second tier" of audit firms. I dislike using that term because it implies that the firms are secondary in quality – which I strongly believe is false..." (PCAOB member Kayla Gillan in speech to Association of Corporate Counsel, October 24, 2005)

In the UK, more detail is required about how conclusions of independent audit inspections are reached. The second AIU report has caused confusion among even experienced commentators. Some have interpreted it as an attack on the Big 4's audit quality, and others as posing questions about the consistency of audit quality outside the Big 4. Given that confusion we welcome the FRC's consultation on publication of the AIU reports.

We would encourage the FRC to bring greater clarity to the outcome of referrals made to the Financial Reporting Review Panel (FRRP). There were three referrals to the FRRP arising from the AIU's inspections this year and two last year. Some commentators have speculated about these referrals and sought to undermine the quality of UK auditing. We recognise that reports which were developed for private consumption should not necessarily be made public for reasons of confidentiality. As is the case with lawyer's professional privilege, there must be some private reporting. That said, to reduce the potential for speculation, we would like to see the FRC confirm what action (if any) had been taken by the FRRP in response to these referrals. We believe this would give a clearer picture of the results of the AIU's findings.

More broadly, the AIU report must be put into context. The aims of the AIU, namely an improvement in audit quality, should be achieved over time, but the capital markets would not be well served by being offered false promises/prophecies: there will be corporate failures in the future and some of these will be accompanied by less than excellent audits. However, isolated instances do not invalidate audit quality as a whole. In addition, we believe the AIU's file selection might have led to flawed conclusions in certain regards. For example, the suggestion that smaller audit firms are more likely to provide services not in accordance with the Ethical Standards, such as tax journals. Grant Thornton has not provided this service since the introduction of the new standards. We have evidence this issue is one relating to the size and resources of audited entities, not the size of the audit firm.

This is a learning process for both the AIU and the profession. Audit firms should focus on key measurables, such as improving documentation of key decisions and linkage of audit quality to remuneration which the AIU has identified as an issue across all or most firms. We would be concerned if the future style of public reporting drove the sort of 'box-ticking' requirements of which investors are so fearful.

Key actions by regulators (auditor liability reform)

Auditor liability is primarily a public interest issue rather than a competition one, although it has a key bearing on choice. Disappointingly, the Company Law Reform Bill did not specify proportionate liability, which has the broad support of all key stakeholders and is broadly neutral to choice. Inappropriate liability clauses will further hamper choice.

The FRC (in consultation with the DTI) has a key role to play in providing guidance to ensure liability clauses in audit engagement letters specify proportionate liability. Indeed, over time, proportionate liability should create greater appetite among more audit firms to invest in increasing their involvement in auditing larger public companies.

We also urge the FRC to engage with the liability reform debate within the EU and to encourage the introduction of appropriate liability reform throughout the EU.

Key actions by standards setters

In developing new audit rules, standard setters should ensure that they involve, and are seen to involve, members of the profession from non Big 4 firms in the process and to take note of their views. Currently, there is a perception that the needs of small and medium public companies are being ignored, and that an assumption exists that only the Big 4 "know what is going on". Clearly, this is counterproductive and unsatisfactory.

The reality is that usually other leading firms do contribute their views and do know what is going on but their involvement tends to be less visible than that of the Big 4.

A recent example would be the EGAOB IFRS roundtable. While Grant Thornton provided input to this debate via FEE (Fédération des Experts Comptables Européens) rather than being present at the event, the perception exists that only the Big 4's views count.

Other matters

We are in favour of market-led solutions to address the problem of choice, which are more likely to work than artificial intervention from regulatory bodies. We do not support artificial regulatory intervention unless this can clearly be seen to improve audit quality. We are not persuaded that either the break up of a Big 4 firm, the rotation of audit firms, additional restrictions on the provision of other services or joint audits would achieve these ends.

We would encourage investors to debate the merits of voting on audit committee reports as a means to improve audit quality and choice. We appreciate that there are issues to overcome, such as liability and duty of care.

There has been some comment that audit fees are increasing at a faster rate in FTSE 350 market (where there is currently almost no perceived choice outside the Big 4). Given the pace of regulatory change we do not believe that audit quality will be improved by cutting fees but it is not immediately apparent why audit firms have not been able to increase fees to the same extent outside the FTSE 350, where there is, in practice, more choice.

Summary of potential actions for the FRC

- Encourage investors to express views on competition and choice following the statement from the ABI
- Provide a mechanism through which investors have a platform for better expressing their needs and reacting to proposed new regulations and standards
- Demonstrate UK leadership by engaging with global investor groups like the ICGN to consider issues such as competition and choice and corporate governance
- Review the way in which the AIU's findings are published (this step is in hand)
- Issue authoritative guidance for liability clauses, which specify proportionate liability in audit engagement letters
- Encourage appropriate liability reform in the EU
- Maintain momentum of the current debate on competition and choice
- Encourage key standard setters to involve and be seen to involve audit firms outside the Big 4

If you have any questions on this response, please contact my colleague Steve Maslin (Tel: 0870 991 2736; email steve.maslin@gtuk.com) in the first instance.

Yours sincerely

Michael Cleary
National Managing Partner
For Grant Thornton UK LLP

Appendix A

- Q1 *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 the market?*

Briefly, no. The focus should be on companies on the Full List. The market segment outside the top 150 or so companies is where significant structured improvements can be made in the short and medium term. The risk is that if debate focuses on the very largest public companies nothing constructive will happen.

- Q2 *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?*

The key matter is to increase the number of active auditors in the listed company market. If that can be achieved, other concerns will be easier to deal with.

There is a problem with placing too great an emphasis on protecting the Big 4's interests (perpetuating the myth/argument that a Big 4 firm is "too big to fail"), since this could lead to a loss of audit quality.

- Q3 *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.*

This is covered in the main letter.

- Q4 *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:*
- (a) All firms: for example, how firms could provide further information to audit committees to facilitate comparisons across different types of firms.*
 - (b) Non-Big Four or new firms: for example, how the firms seeking to supply audit services to this market could better demonstrate their capabilities.*
 - (c) 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.*
 - (d) Companies and their audit committees: for example, how companies could develop working relationships with a wider range of audit firms to help them to evaluate tenders.*
 - (e) Investors: for example, how investors could support audit committees in evaluating auditors and in selecting from a wider range of audit firms.*
 - (f) Lawyers, investment bankers and other advisers: for example, how advisers' could support audit committees in evaluating auditors.*
 - (g) Legislators and regulators: for example, how existing laws and regulations could be modified in order to make auditor changes less costly or risky.*
 - (h) Other stakeholder groups.*

This is covered in the main letter.

- Q5 *We invite views on:*
- (a) The combination of steps that would be most likely to lead to increased choice.*
 - (b) Whether these steps could be taken forward by market participants, or whether existing laws and regulations may constrain or prevent this.*

- (c) *The costs of the steps relative to the risks arising from the existing or potential degree of concentration in the market.*

This is covered in the main letter.

- Q6 *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:*
- (a) *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.*
 - (b) *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.*
 - (c) *Investors: for example, how investors can support companies and their audit committees in responding to new information about potential problems faced by audit firms.*
 - (d) *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.*

This is covered in the main letter.

- Q7 *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:*
- (a) *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.*
 - (b) *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.*
 - (c) *Investors: for example, how investors could support companies and their audit committees in responding to the loss of an audit firm.*
 - (d) *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.*
 - (e) *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.*
 - (f) *Other stakeholder groups.*

This is covered in the main letter.

Wednesday, 14 June 2006 Ref: 48/06

ABI Investment Committee encourages companies to consider all contenders when selecting an auditor

The ABI Investment Committee today released a statement encouraging companies to have an open mind and consider all choices when appointing auditors. The statement responds to concern raised by the Financial Reporting Council (FRC) and others that the provision of audit services to listed companies is too heavily concentrated in the Big Four accounting firms.

Peter Montagnon, the ABI's Director of Investment Affairs, said:

It is important that companies approach this choice with an open mind. Investors are content for companies to choose an auditor from outside the Big Four, if this suits their circumstances. By making this clear, we are helping to promote greater choice. This contribution from investors should make a difference over time, but it is only one of many measures that are needed if market participation is to gradually expand.

- ENDS -

Notes

1. Selection of auditors statement by the ABI Investment Committee

The ABI Investment Committee has noted concerns raised by the Financial Reporting Council about the degree to which the provision of audit services to listed companies is concentrated among the Big Four accounting firms. According to the FRC, the Big Four currently audit 99 per cent of FTSE 100 companies and 97 per cent of FTSE 250 companies. The Committee, which represents large investors controlling nearly 20 per cent of listed shares, agrees that it would be appropriate to encourage greater diversity and choice.

The Committee therefore wishes to make clear that, as large shareholders, its members do not consider it appropriate or necessary for the selection of a Big Four auditor to be the default choice for every listed company. They believe that companies should periodically review the desirability of appointing a new auditor. When they do so, they should consider all possible contenders, including the appointment of an auditor from outside the Big Four. It is important that audit committees approach this choice with an open mind and on the basis of a level playing field. They should take account of the specific needs of the company and should not prejudge the response of investors. Shareholders are happy to be consulted by companies if audit committees are uncertain how their choice may be received.

The Committee believes that, over time, the adoption of the approach outlined above will lead to a reduction of concentration, particularly for companies at the middle and lower end of the market. They do not wish to be prescriptive and recognise that each company should make a choice that reflects its own particular circumstances. However, the Committee will be pleased if this clarification by investors contributes to an increase in choice without sacrifice in standards.

2. Enquiries to:

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3. The ABI is the trade association for Britain's insurance industry. Its nearly 400 member companies provide over 94% of the insurance business in the UK. It represents insurance companies to the Government, and to the regulatory and other agencies, and is an influential voice on public policy and financial services issues. ABI member companies hold up to a sixth of all investments traded on the London Stock Exchange, on behalf of millions of pensioners and savers.

4. An ISDN line is available for broadcasts.