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Dear Mr Rose

Response to FRC Discussion Paper on Choice in the UK Audit Market

Thank you for your invitation to contribute to the debate on competition and choice in the UK audit market. Our response is attached.

Please note that Independent Audit Limited does not undertake financial statement audits. Our comments are based on our work with investment institutions and clients, whom we advise on a range of governance-related matters, including the effectiveness of their external audits.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Jonathan Hayward'. The signature is fluid and cursive, with a long horizontal stroke at the end.

Jonathan Hayward

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Introduction

1. Q1 of the Discussion paper asks if the focus of the debate should be on the choice of auditor available to large public companies. We agree that it is reasonable to focus the present debate on large public companies. However, the Discussion Paper appears to presume an over-restrictive interpretation of "choice".
2. There are two important questions not addressed in the Discussion Paper. These are:
 - Who is doing the choosing?
 - On what criteria do they make their choices?
3. If these questions are not to be fully considered, the discussion is not actually about "choice" and the Discussion Paper could helpfully be retitled "Sufficiency of Supply".
4. Ensuring sufficiency of supply is a worthy goal. However, if the focus of debate is to be limited in this way, it should be made explicit, as dissatisfaction amongst those with an interest in large company audit is not necessarily limited to the adequacy of supply.
5. There are a number of reasons for extending the focus of this debate so that it is about choice based on an informed understanding of quality, with quality defined in terms relevant to shareholders, rather than merely about sufficiency of supply. These include:
 - Increasing real choice is likely to have a more sustainable effect on supply than simply patching the present system.
 - Of the various criteria that might be used for selecting an auditor, such as cost and the ability to work with management in the UK and abroad, the technical quality of audit is the most relevant to the interests of shareholders.
 - The fact that audit is a statutory requirement enforced by a substantial regulatory framework, rather than being left to the voluntary decision of shareholders, indicates that there is a public interest in it. Technical quality of audit is the only criterion for choosing an auditor which is relevant to the public interest.
 - Disquiet about the present system of audit is not consistent but is widespread, ranging from executives questioning value for money to some investors questioning whether it is worth having at all. This suggests that the opportunity for a wider look at the system should be taken.
6. We agree with the criteria for evaluating opportunities for mitigating risks set out in your Q2, particularly that solutions should be market-led and maintain or improve quality as well as choice. If the debate is to be on these terms, it is necessary to consider:
 - Whether audit quality can be made more visible
 - The role of investors in the selection and reappointment of auditors
 - Reducing the perceived barriers to entry
 - The effect of liability



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7. Changes in these areas as discussed below would encourage the development of a properly competitive market with an attractive balance of risk and reward (your Q3). We think it unlikely regulators or legislators can achieve more by any other means.

Visibility of audit quality

8. Except on the rare occasions when an audit failure means that quality is visible by its absence, audit quality is not transparent to shareholders or any other external user of audit opinions. They therefore have no basis for choosing auditors other than a firm's reputation and ability to offer indemnity. This has been a significant factor in encouraging the concentration of large company audits into a handful of large firms.
9. Auditing standards, which are intended to maintain quality, are written almost exclusively in terms of the process employed by the auditor and contribute to the lack of transparency. By ensuring that every audit process follows the same pattern and every audit opinion the same words, they make it more difficult to differentiate.
10. There has been relatively little debate around how audit quality might be indicated, but suggestions that have been made include:
 - Long form audit reports that enable the auditor to demonstrate knowledge of the company and expertise in making judgements.
 - Other changes to auditing standards that would permit greater flexibility in approach, combined with disclosure of the approach followed and the work done.
 - Disclosure of key inputs such as the experience of key team members.
 - Publication of AIU reports, possibly combined with a more qualitative approach to review.
 - Shareholder access to auditors.
11. Although there are practical difficulties with these and other suggestions, there is no reason to suppose that all such difficulties are insurmountable. In view of the importance of achieving greater transparency of quality, the FRC should encourage further debate in this area with a view to making trials in the near term.

The role of shareholders

12. Audit quality is more visible to the managers of the companies being audited than it is to shareholders. However, asking managers to make this their top priority is akin to asking motorists to be responsible for the quality of traffic policing. They could be expected to have an active interest in the maintenance of a service that keeps the traffic flowing, but it would be naïve to expect them to feel the same interest in the maintenance of speed cameras.
13. In the same way, even the most conscientious company managers will judge the quality of the audit primarily in terms of its usefulness to them as managers, rather than its usefulness to shareholders. It therefore follows that, if auditors are to be chosen on the basis of their quality



of work to shareholders, the shareholders need to play a more active part than they have traditionally done.

14. A number of suggested mechanisms have been put forward. In some other countries there is the example of audit appointments being made by shareholders' committees. In this country the investor institutions have so far shown relatively little interest in auditor appointment. The FRC should therefore stimulate debate to gauge their real level of commitment and determine what approach might be practicable.

Reducing the perceived barriers to entry

15. A significant barrier to new entrants in the large company audit market is the presumed need to have a large and well-integrated global network, which only the largest firms possess. The role of such a network in the audit of a multinational is primarily to undertake the statutory audits of subsidiaries.
16. The main beneficiaries of a globally integrated audit which encompasses all the subsidiaries – and therefore provides assurance on individual entities – are the board and the financial management of the company concerned, rather than the shareholders. But their needs for assurance and information can be met in other ways, such as enhanced quality of internal audit.
17. Before modern developments in information processing, and the consequent developments in methods of management and control, the only way to audit a multinational company was indeed to audit the component parts and then add them up. However, this is no longer the case. It is entirely feasible, and to a limited extent sometimes already happens, for a firm to audit the consolidated accounts of a multinational company, undertaking whatever work at local level is necessary for that purpose, while another firm or firms perform some or all of the local statutory audits. (While this might appear to duplicate cost, in practice the effects are mitigated by the fact that the group auditor will be selective in the work done and the company is free to choose lower cost providers in individual locations.)
18. In such a case, the resources required by the parent company's audit firm are substantially smaller. In particular, it does not require the same access to a large and well-integrated global network of member firms. In other words, this barrier to entry can be removed, or at least substantially diminished, by the simple expedient of encouraging companies to separate the audit of the consolidated accounts for shareholders from the statutory audits of subsidiaries.
19. Short of direct regulatory intervention, there are some things that could be done to encourage this separation:
 - Ensure that there are no regulatory barriers
 - Provide guidance to audit committees on making a clear distinction between the audit for shareholders and audits done for internal assurance or compliance purposes
 - Require disclosure of audit arrangements relating to subsidiaries and the audit fees and hours spent by the parent company's audit firm on the statutory audits of subsidiaries



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20. Audit firms may have internal policies that prohibit them from taking an audit appointment where a substantial proportion of the company's subsidiaries are audited by other firms. This rests upon the presumption that the group auditors will place reliance on the audit opinions provided by such other firms, rather than undertake their own work independently of the statutory audits. As this presumption would no longer be valid, the audit firms should be able to modify their policies.
 21. A further barrier to entry is the technical complexity of accounting, particularly under IFRS. The understandable desire of companies to know that their interpretations and applications are consistent with general practice means that there is considerable benefit to them in using an audit firm with a large client base. This barrier could be overcome if information about interpretation and application of IFRS was freely available, rather than being held as the proprietary knowledge of individual audit firms; this could be achieved either by requiring firms to provide open access to their IFRS databases or by establishing a central repository.
 22. Investors' preference for Big Four audit firms is frequently given as a reason for not choosing smaller firms. There is some reason to suppose that this is myth rather than fact, and it is encouraging that some investment institutions have taken the initiative to dispel it. It would be helpful if more institutions – and investor bodies – were to do likewise.
 23. Even without participating in the selection of auditors, investors can and should do more to communicate their preferences. In particular, if they do not have a preference for a Big Four firm to be an auditor, they should make this explicit in order to prevent their supposed preference from being used as an excuse by those who do not wish to consider change.

Liability

24. The changes suggested here require greater transparency and a commitment to change. Neither is likely if fear of liability and the high cost of exposure management remain driving forces for audit firms. Changes designed to increase real choice in the audit market must be accompanied by a real reduction in auditor liability.
25. On the other hand, any steps taken to discourage firms from withdrawing from the audit market should be viewed as strictly temporary. In a properly functioning market, in which more real choice is available, firms whose quality is inferior should lose out to those who can provide better quality. The worst effects of a firm withdrawing from the market could be mitigated by permitting its former clients to operate for a period of time, say up to two years, with no auditor.

Further matters for debate

26. The Discussion Paper asserts that audit is a cost-effective way of increasing confidence in financial information. Can this assertion be proven and has it been challenged?
27. As long as audit remains a statutory requirement, its value will be difficult to demonstrate. One possibility would be to abolish the statutory requirement and leave it to each company's shareholders to decide whether they wanted one. If they did, it would have the beneficial consequence of causing the shareholders to be engaged with the selection and appointment.



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28. If shareholders did not require an audit, but instead placed all responsibility for the integrity of accounts on the directors, it might result in directors commissioning audits to provide assurance for themselves. This would mean that audit would be purchased by people who have direct exposure to the audit, thus overcoming some of the problems of lack of transparent quality.
 29. It would also enable the auditors to function properly as part of the company's "right first time" process, rather than – as at present – leaving them in the uncomfortable position of being forced to be less helpful to management than they might, in order to maintain an appearance of "independence".
 30. Finally, consideration of the market for audit is incomplete without consideration of what the purpose of the audit service actually is, which requires consideration of the purpose to be served by audited accounts. This stewardship/decision-usefulness debate has an obvious bearing on this. And at a more immediately practical level, the volume and complexity of IFRS is in danger of turning the audit into an exercise in ensuring compliance with accounting standards. Is this what we want a "quality audit" to be?