



Institute of Directors

Choice in the UK Audit Market

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This paper gives the Institute of Directors' comments on the consultation *Choice in the UK Audit Market* issued by the Financial Reporting Council in May 2006.

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Choice in the UK Audit Market

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The Institute of Directors

Founded in 1903, the Institute of Directors (IoD) is an independent non-party political organisation of individual members and now has some 53,000 individual members. The membership is drawn from across the business spectrum. 84% of FTSE 100 companies and 70% of FTSE 350 companies have IoD members on their boards, but the majority of members (about 70%) are directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies. The organisations from which our members are drawn employ over 10 million people in the UK, i.e. over 40% of the workforce.

The IoD's aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole.

Introduction

The IoD welcomes the Financial Reporting Council's decision to open this subject to public discussion and debate. It is one that has been developing for a number of years, but has not to date been afforded an open public debate.

What is most surprising is not the dominance of the Big 4 in the FTSE 100, but their dominance in the FTSE 350. This tends to show that perception of ability is more telling than the actual ability to meet corporate and shareholder requirements for audit. Companies, shareholders and advisers must be encouraged to look at their real audit requirements and decide whether a Big 4 auditor is necessary for them. The discussion paper enables these considerations to take place more easily.

Outside the actual provision of audit services it is necessary to ask whether the Big 4 unduly dominate policy issues in a way that has a distorting effect on the audit market.

Answers to Specific Questions

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 this market?*

Choice is an appropriate focus for the debate, because it encompasses the underlying concerns that a real lack of choice engender.

If a company has, or even if it perceives that it has, no real choice it does not have a sound basis for assessing performance of the auditor and the quality of audit. Quality of audit can also be affected at a wider level by the influence of a narrow range of firms on both the scope and the regulation of audit

While cost of audit has not been identified as a primary factor in the selection of auditor, the cost of and the disruptive effect of tendering are factors both for companies and for those who might aspire to break into the large public company market. Potential auditors often perceive (whether rightly or wrongly) that they are being used to give an impression that a genuine tendering process is taking place even though there is no real intention by the company to change auditor. In these circumstances they are unlikely to devote adequate time and effort to tendering to make the breakthrough. Periodic tendering should become the norm, and entering into the process should carry no connotations of dissatisfaction.

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?*

Mitigation of risk will involve widespread behavioural changes. These are not readily susceptible to regulatory intervention, so that should not be the favoured route. The market should be capable of ensuring that the risks are mitigated. Changes in behaviour will be required from a wide range of entities: companies, audit committees, audit firms, advisors and sponsors, investors, lenders and regulators among others. There is still a general tendency to see a Big 4 audit as conferring some reassurance that is not given by audit by a smaller firm. It is likely that for the vast majority of the FTSE 250, and even for some FTSE 100 companies, the international spread and greater research facilities of the Big 4 are unnecessary for a good quality audit.

Q3. *We invite views on how different groups, acting individually or collectively, could increase the propensity of non-Big 4 or new firms to seek to be major players in the market for audits of large companies.*

As stated in answer to question 2 this requires behavioural changes across a number of players. Aspects that could assist include:

- Companies should be encouraged to tender periodically for their audit, with clear criteria evaluation of effectiveness and for selection. Non-Big 4 firms will to consider it worthwhile participating in the tender process. Audit committees being more prepared to go out to tender on audit with a view to a genuine evaluation of all the bidders and ultimate selection of the most appropriate. Again investors can play a part by indicating that they would support the time and effort spent on the exercise and would not set up inappropriate opposition to change. There is anecdotal evidence that at present tenders involving non-Big 4 firms are seen to be a window dressing exercise. Unless they see a real chance of securing the audit non-Big 4 firms will not invest the appropriate time and resources in the tendering process.
- Where companies come to the market a proper evaluation of the company's existing audit arrangements would be appropriate. This is particularly true where the business does not operate in international locations not covered by its existing auditor.

Q4. We invite views on how the propensity of companies and their audit committees to purchase audit services from non-Big 4 firms could be increased.

See our answer to question 3.

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 cost of the steps relative to the risks arising from the existing or potential degree of concentration in the market.**

We would reiterate that behavioural change is required from a large number of different parties. This is more likely to come about through action by market participants. The IoD considers that this is not an appropriate time for regulatory intervention. The airing of the issues and opening up a debate may of itself be enough to precipitate the necessary changes in behaviour. However, results should be kept under review. If over the next few years there is seen to be no change in patterns of tendering for audit and in engagement of a wider range of firms particularly among FTSE 250 companies there may be a case for light touch regulation, possibly in areas such as a 'comply or explain' approach to tendering. While some very large companies in particular sectors would legitimately be able to argue that they are constrained in their choice of auditor, this would not be the norm. However, this should not be seen as advocating compulsory rotation of audit firms. The IoD does not believe that this is in the best interests of companies, investors or the audit firms.

Q6. We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market.

At its most basic the answer lies with the audit firms. They should ensure that their practices and controls are sound and robust. They should organise their activities so that they are not vulnerable to the sort of domino effect that overtook Andersen's. It is as important for audit firms to have sound internal controls as it is for the companies they audit.

The IoD does not believe that the answer lies in the hands of companies, investors or regulators.

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 market.

We have no comments on this question.