



**FRC Discussion Paper: Choice in the
UK audit market**

Response from KPMG LLP

KPMG LLP

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1 Introduction

1.1 The FRC paper

The FRC discussion paper “Choice in the UK Audit Market” (the FRC paper) poses a number of questions and seeks views from all key stakeholders in the listed company audit market on the current market environment and potential changes in the future.

KPMG LLP (KPMG) is fully supportive of this process and we are pleased to submit this memorandum which summarises our views on these important issues. .

1.2 Market background and development

In order to set our responses in context, we set out our views on the background to the current market and the changes necessary to ensure a vibrant market that encourages new entrants and avoids unnecessary collapse of existing participants.

The current situation is a direct result of regulators permitting the Price Waterhouse/Coopers and Lybrand merger and the criminal prosecution of Arthur Andersen in the US which caused the rapid collapse of the Andersen network. That this action was disproportionate is obvious. It is noteworthy that the original conviction was subsequently unanimously reversed by the Supreme Court, but too late to save the Andersen network.

The issue of concentration is a global issue and, the appropriate solution can only be arrived at on a global basis taking account of market forces. The solution is likely to involve the merger of mid-tier firms. Any such merger would require significant investment. In order to give a reasonable chance of an adequate return on the required investment the following environmental changes are required:

- liability reform in all major economies where there is currently an unlimited liability regime; and
- much faster progress towards convergence of accounting and auditing standards. The current process of convergence is far too often delayed by a combination of political and regulatory intervention as well as technical difficulties. Convergence will lower costs for new entrants to the audit market as well as for corporates and will provide investors with more meaningful information.

Finally, a vibrant market requires major regulators to develop global protocols for a measured and proportionate response to alleged poor quality work by individual audit partners or offices. The regulatory responses to Andersen following the collapse of Enron and to PwC following recent issues in Japan were not measured or proportionate.

1.3 The Oxera report

1.3.1 Context

The report “Competition and Choice in the UK audit market” (the Oxera report), jointly commissioned by the FRC and DTI, was originally recommended by a working party of the Audit Quality Forum in 2005 following an initial review of the current market conditions within the UK audit market.

The AQF is comprised of representatives of all stakeholders of UK audits including the auditing profession (both Big Four and non-Big Four firms), regulators, corporates and the investor community.

The AQF recommended that external research be undertaken to understand the dynamics of the audit market.

KPMG fully supported the AQF’s recommendations and provided two members of the working party.

1.3.2 Key findings

The Oxera report correctly identifies that the large company audit market is highly concentrated amongst the “Big Four” firms and that significant drivers of this concentration are reputation and greater capacity and international coverage for serving global and complex organisations.

Reputation was correctly identified as an important driver of choice. Such reputation is only achieved by significant investment in creating an international network, in developing and enhancing audit methodology and recruiting the required pool of skilled professionals. Only with this combination can high quality audits be delivered consistently around the globe in the public interest.

Oxera also correctly identifies that audit fees have risen in recent years as a result of additional regulation. However we do not concur with the conclusion that audit fees have risen directly as a result of higher concentration within the market.

Oxera suggests that entry into the large company UK audit market is unlikely to be attractive to any potential new entrant under the current conditions and that, in the event of the loss of another major audit firm, further reductions in the barriers to entry would be needed to encourage any potential replacement for this firm. Whilst it is up to others to decide on the merits of entering the large company audit market, we concur that the loss of one of the Big Four firms would be a significant concern for investors and the capital markets, as well as for the remaining major audit firms and could create a major policy issue for regulators and the governments globally.

1.4 UK regulatory response post-Enron

Following the collapse of Andersen in 2002, regulatory authorities in the UK took time to consider the appropriate response to the situation, ensuring that significant consultation

took place between all key stakeholders including the accounting profession and audit firms, and the corporate and investor communities. This measured response built on the reforms to the UK Corporate Governance and regulation of the Accounting Profession that had been enacted in the UK following scandals such as Maxwell and BCCI

This consultation process avoided the immediate legislative remedies that were enacted in the US, and instead brought in a number of more measured responses including the creation of an independent regulator, the FRC, and an inspection process that provided a robust review of the audit profession, without placing unnecessary administrative burdens on either the corporate community or on audit firms.

The current FRC consultation paper should be seen as a continuation of this measured response which has ensured that the UK continues to be a world leader in corporate Governance and Financial Reporting.

1.5 Global audit market

The FRC paper notes that the characteristics of the UK audit market are shared with other markets worldwide, and that regulators in these markets have similar concerns over the competitive environment for audit services in their jurisdictions.

We strongly believe that this is a truly global issue and that any proposals for future changes to increase choice in the UK audit market are considered in the widest possible context with regard to the viability of such proposals in other global markets.

2 Risks arising from the competitive environment

Q1 – Do you agree 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?

2.1 Current UK listed audit market conditions

A competitive marketplace is vital to a thriving and high quality auditing and accounting profession and, in turn, to confidence in financial reporting and capital markets. Other regulated markets have benefited considerably from greater competition including telecommunications, utilities and aviation.

KPMG has been consistently vocal in its support for healthy competition. It is fair to say that in the market for the largest global audits there is fierce competition between the major firms but not a wide range of effective choice. In tax and other advisory services, there are many niche or boutique providers in the market extending the choice for business.

The consolidation of the global professional services industry from eight major providers in 1995 to the “Big Four” post the demise of Andersen has led to understandable concern in the market and among regulators at the reduced level of choice. Indeed, given that a global corporate can have two or even three of the Big Four firms as suppliers of non-audit services which may threaten their independence as external auditors or actually prohibit them being appointed auditor in some jurisdictions, choice can be even more restricted.

These changes (apart from the unplanned collapse of Andersen) were driven by:

- the need for effective global networks able to provide a high quality audit and range of services to meet the increasing global requirements of clients, in particular the recent expansion of emerging markets such as China, India and Eastern Europe;
- increasing complexity of the market and need for more industry-specific training and expertise;
- increases in risk exposure and the need to be able to draw on a larger capital base;
- the need to attract the best pool of talent; and
- economies of scale spreading the costs of overheads (eg new technology systems) to enable greater price competitiveness.

Post-2002, other factors have favoured larger networks with the need to invest to meet new regulatory requirements, increased market pressure for integrity, a greater focus on

independence and the need for greater protection against major claims. These pressures include:

- regulatory compliance including registration (in different jurisdictions), annual returns and inspections together with a need for greater disclosure. While this is all welcome, compliance costs often present a barrier to market entry;
- increased liability exposure with insurance being more expensive and, often, impossible to obtain;
- a welcome focus on Independence and Ethics has greatly increased the cost that major networks incur on compliance presenting a significant barrier to entry;
- market pressure has favoured audit firms with the highest global reputation;
- audit Partner rotation requirements mean that firms must have the scale and capacity to be able to rotate partners with sufficient industry-specific knowledge; and
- developments in International Accounting and Auditing Standards have required increased investment by firms in technical expertise. However, there have been some developments favouring mid-tier firms. In particular, market pressure for Audit Committees to pre-approve non-audit services provided by the auditor and exercise much more caution before automatically awarding such work to the auditor. This has opened up the non-audit market especially to the middle-tier firms.

2.2 Focus of the debate

We firmly believe that the focus of this debate should be on the degree of choice in the market for audit services rather than other features such as competition or price. We welcome, however, the current FRC project on the drivers of audit quality which is an important element of the choice debate.

2.2.1 Choice

By approving the merger of Price Waterhouse and Coopers & Lybrand in 1998, regional and global regulators satisfied themselves that significant competition would remain in the large company audit market amongst the proposed five firms going forward. We do not know what the regulatory reaction would have been to the proposed KPMG/Ernst & Young merger that was being discussed at the same time. In any event, in the UK PricewaterhouseCoopers combined three of the former Big 8 firms and audits more than 50% of the FTSE 100. It is difficult to see how this merger was in the public interest specifically in the UK or more generally.

The collapse of Andersen in 2002 reduced this number to the four firms we have today, the Big Four. The transition of Andersen clients and staff was not made globally to one of the Big Four firms, but individually on a country-by-country basis.

This process was aided by Andersen having the smallest audit client base of the five firms. We do not believe that the change in the marketplace following the collapse of Andersen is so significant as to invalidate the conclusions drawn by the regulators in permitting the merger of Price Waterhouse and Coopers & Lybrand. It is however important to note that we do not consider that such a process would be as smooth if one of the Big Four firms exited the audit market. This is discussed in further detail later in this response.

As a result of a merger of two firms and the high profile demise of another, the market for the audit of large multi-nationals has been left with four participants. Buyers will always want more choice all other things being equal. The question is however, whether there are now too few players in the market. It is noteworthy that there are examples of other global markets where there are fewer than four players; civil aircraft manufacturing and aero-engine manufacturing, for example.

Oxera reported that over one-third of FTSE 350 audit committee chairs surveyed did not feel they had sufficient choice of auditor. Clearly, this implies that around two-thirds feel they do have sufficient choice, which is a positive indication that a clear majority of audit committee chairs are not unhappy with the current level of choice.

However, in certain industries, such as financial services, the Oxera report highlighted examples where individual corporates felt they had little or no choice. This appears to arise as a result of lower industry specialist presence and specific independence rules.

2.2.2 Competition

We were pleased that the FRC paper focussed on choice in its paper rather than competition, as we believe from our experience of competing for the audits of listed companies, that the Big Four compete fiercely when such opportunities arise.

A significant amount of time and cost is invested in the tender process for existing and new audit clients. Like any competitive business, retaining existing clients and gaining new ones is the lifeblood of our business and we will continue to pursue this strategy.

2.2.3 Price

We share the view taken by the FRC that the audit market needs to remain sufficiently profitable to at least attract and retain the breadth and depth of talent to carry out quality audits.

The Oxera report notes an increase in audit fees well above the rate of inflation, which we do not consider to be the most appropriate comparator in this case. A salary index rather than a retail prices index would better reflect the general costs condition the audit firms have experienced over the 10-year period under review. It is also important to recognise the impact that the huge change in accounting and auditing standards and regulation and has had on the work that audit firms must undertake.

We do not agree with the Oxera conclusion that prices increased directly as a result of increased concentration. We believe that the factors affecting price are too complex to arrive at the conclusions drawn by Oxera. In this connection, we note the conclusion in the 2003 US Government Accountability Office study that there was no empirical evidence that competition in the audit services market has been impaired to-date.

We understand the FRC are undertaking further research on audit pricing and await those results with keen interest.

2.2.4 **Audit quality**

Oxera note both reputational risk and unlimited liability as the two factors likely to ensure auditors are encouraged to perform a quality audit despite the fact that a company might be significantly limited in its alternatives.

As a firm providing a vital service to the capital markets, our own professionalism and maintenance of our reputation demands that we perform our audits to the highest possible level. Lapses in audit quality have the potential to damage reputation with resultant severe financial consequences. However we do not accept that unlimited liability has any positive impact on audit quality. The draft London Economics report prepared for the European Union¹ refutes this assertion.

In 2004/2005, the Audit Inspection Unit (part of the FRC) undertook its first independent reviews of the Big Four and reported on them as a whole. The second report of the AIU was published in July 2006.

Both reports indicated that no systemic weaknesses had been identified within the Big Four firms and that the audits reviewed had generally been conducted to a high or acceptable standard and the overall quality of auditing in the UK to be fundamentally sound.

Audit quality is at the heart of our business strategy and we will continue to implement any recommendations of the AIU for improving our processes.

¹ Study on the Economic Impact of Auditors Liability Regimes, London Economics, July 2006

3 Promoting increased choice

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?

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. (Examples omitted.)

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.

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.*

3.1 Market-led initiatives or regulatory intervention?

In some markets regulatory intervention is necessary to prevent the market from operating outside the interests of the people they serve.

Within the audit environment, there has been significant regulatory intervention in the aftermath of the Andersen collapse. The independent regulation of the UK auditing profession, by the FRC, has been welcomed by all stakeholders, including the auditing profession itself as a means of providing a robust, independent oversight function instead of what was often perceived as self-regulation by the various professional bodies.

As globalisation gathered pace in the largest end of the corporate market, global auditing networks were required to provide a seamless audit service to these organisations.

The largest audit firms responded to this by merging their operations to be able to provide global organisations with global access to the same audit network, to a position where there were five large audit networks each with comprehensive global coverage.

The demise of Andersen has meant that only four firms of a similar size globally now remain and it is clear to all that no further mergers are likely to be allowed by global regulators. Based on the global reach of each firm set out in the Oxera report, there are no grounds for allowing such a merger.

The FRC paper raises some regulatory options that have been proposed in the past and seeks views on how the market participants and other stakeholders can promote increased choice in the UK audit market.

During consideration of any regulatory intervention, a comprehensive regulatory impact assessment is necessary to demonstrate that such intervention is warranted over market-led action.

We set out our views on both aspects in the remainder of this section.

3.2 Market-led initiatives

3.2.1 Mergers or organic growth

As for other markets, competition is good for the audit market and we would welcome increased competition from one or more entrants to the market.

In its analysis of the possibility of entry/expansion by a mid-tier firm into the large company audit market, Oxera focussed on the significant investment required (to acquire a credible reputation, an extensive international network and associated resources and expertise), long payback period and significant business risks and concluded that it did not seem to be economic as a pure financial investment exercise.

Its analysis did not consider a merger of one or more of the mid-tier firms to gain the additional resources and technical capabilities and increased international network that were said by Oxera to differentiate the Big Four from the mid-tier firms.

As noted previously, the Big Four, including KPMG, have achieved their current scale through a combination of organic growth and mergers and Oxera could perhaps, usefully, have considered the option of a merger amongst the mid-tier firms. This would clearly need to be a market-driven solution and undertaken on an international basis; we do not underestimate the difficulty in this being achieved.

The decision to pursue a strategy of growth either organically or through mergers will depend on those firms' appetite for competing with the Big Four firms and the speed at which they wish to do this, if at all. The likelihood of such mergers succeeding would be greatly enhanced by:

- liability reform in all major economies where there is currently an unlimited liability regime; and
- a faster process of convergence of accounting and auditing standards. Currently progress is slowed by a combination of political and regulatory interference as well as the inevitable technical difficulties. Convergence will greatly reduce the cost that new entrants will incur in building technical expertise on a global basis.

3.2.2 **Corporate and investor community perceptions**

Oxera rightly placed significant emphasis on reputation as being a key driver of choice in the large company audit market.

Audit committees have more recently, through corporate governance requirements, been tasked with evaluating the effectiveness of the external audit function prior to recommending whether it is appropriate for the current auditors to remain in office. It is important that audit committees have the appropriate information on firms capabilities including audit quality to enable them to decide which firms should be invited to participate in any tender process that is considered appropriate.

3.3 **Regulatory intervention**

3.3.1 **Mandatory audit firm rotation**

Proponents of auditor rotation argue that too long a relationship compromises independence from the client – or at least the perception of independence – and that the auditor can become less challenging due to familiarity and/or too reliant on lucrative non-audit engagements.

Mandatory firm rotation means that clients are forced to look elsewhere and that the incumbent audit firm cannot re-tender and will generally be excluded for a fixed period.

State-enforced rotation cuts across the concept of consumer choice and distorts the smooth operating of the marketplace. Rotation removes the ability of shareholders, audit committees, and boards to debate on which auditors and advisers will best serve the shareholders' interests.

Given the results of the Oxera survey of audit committee chairs which indicated that only 10 out of 50 audit committee chairs would be likely to consider a mid-tier firm, enforced auditor rotation is more likely to result in a process of “taking turns” amongst the Big Four rather than opening up the market to other participants.

The Bocconi study² on the Italian experience with firm rotation suggests that the concentration of mandatory audits had increased between 1992-97 and 2004 from 84% to 95% (number undertaken by the Big 6 (1992-97)/Big 4 (2004)). Thus mandatory audit firm rotation far from opening up the market to greater competition from mid tier firms in fact increases the market concentration of the largest firms. In addition, the study demonstrated that mandatory firm rotation was negative for audit quality and increased cost. The CGAA report issued in January 2003 which rejected mandatory firm rotation explicitly recognised the force of these arguments and noted that there were competition concerns around compulsory rotation.

² The impact of mandatory audit rotation on audit quality and on audit pricing: the case of Italy. SDA Universita Bocconi. January 2005. (*Empirical study of Italy's experience under its mandatory audit firm rotation rule.*)

3.3.2 Forced break up of Big Four firms

The Big Four firms, including KPMG, have arrived in their current state through a series of mergers over the past 100 years, and from a significant investment, on a global basis, in:

- the recruitment, development and training of their staff;
- the development of information technology systems;
- continuous improvement in audit methodologies to meet changing markets; and
- the funding of captive insurance companies to protect against growing negligence claims.

Global networks ensure that clients receive a consistent and reliable audit service regardless of where they operate around the globe.

It has been argued from time to time that competition authorities should break up one or more of the large accounting firms to provide for more competition. Proponents argue that given the Big 4 are ten times the size of the next tier of firms that the break-up route is the only realistic way to increase choice of global firms.

Despite this option being mentioned in the press, we are not aware of any significant support for this course of action by major stakeholder groups.

There would clearly be severe cost implications for the firms and thus for their clients that would need to make choices between successor firms. The resulting smaller firms would be less able to absorb the huge compliance costs and other global and national overheads meaning higher prices. Also, in a period of rapid adjustment to the new environment, it would mean further discontinuity at a time when the markets need a strong pool of talent and expertise and reassurance to support such changes as the US SOX internal controls requirements and the IFRS convergence programme in much of the rest of the world. It is also most unlikely that there would be sufficient expertise within certain segments of the existing networks to adequately resource two successor networks. Examples would include emerging markets such as China and Russia and specific industries such as insurance and oil and gas.

Finally, it is difficult to see how such a break up would be anything other than negative for audit quality.

3.3.3 Mandatory transfer of clients to a non-Big Four firm

We would be very surprised if investors and audit committees would accept a situation whereby they would be forced to select an alternative auditor and at the same time be prevented from selecting another Big Four firm.

Current regulations require audit committees to assess the quality of the external audit function and make recommendations to the Board which are then put forward for shareholder approval.

If the audit committee, Board and shareholders are of the opinion that the incumbent auditor, or another Big Four firm, is the most appropriate firm to provide audit services, good governance is clearly contravened if they are prevented from selecting that firm. We do however (as noted below) support the provision of sufficient information to audit committees to enable them to make an informed choice amongst all audit firms who wish to be considered for any opportunities.

3.3.4 Setting up a state-backed firm

A state-backed firm in the UK may well provide an element of competition in the UK only large company audit market.

It is unlikely, however, that a multi-national organisation would be willing to appoint a state-backed firm in the UK when it will have to use a different network of firms for its international operations.

In order to compete in the UK large company audit market, a state-backed firm would need to recruit a significant level of resource, which could only come from existing firms in the short term. This would weaken particularly the group A firms reducing their ability to compete.

Other obvious questions that arise include the position of liability and remuneration of “partners”. The current partnership structures could not be mirrored in a state-backed firm. If a significant level of protection is offered to “partners” of such a firm, competition would not be on a level playing field.

3.3.5 US Government Accountability Office study

Finally, we would note the conclusion from the 2003 GAO study which confirmed that the majority of respondents would prefer a market-based solution.

3.4 Other considerations

3.4.1 Publication of Audit Inspection Unit audit quality monitoring reports

The AIU has recently published its second annual public report in which it reports on the results of its inspections of the Big Four firms for the second year and “Other Significant Firms” for the first time.

In addition, the Professional Oversight Board has recently published a consultation document seeking views on the form and content of public reporting by the AIU of its audit quality monitoring of the large UK audit firms.

The context in which this matter has been raised centres around the need for audit committees, and ultimately investors, to have the most comprehensive information available in order to make an informed decision when considering the effectiveness of the external auditors and in deciding whether it is appropriate to retain the services of the current auditor or to seek a new service provider.

We welcome the opportunity to participate in this debate and acknowledge that informed decisions can only be made with the right information to hand.

It is important to ensure that those determining the appropriate form and content of future public reporting of audit quality reporting have a clear view of the specific information that the market requires in order to make that informed decision. Any information that is published must set the weaknesses and recommendations in context having regard to the high quality of the vast majority of audits carried out by the major firms.

3.4.2 Relaxation of existing independence rules

The Oxera report identified that a common concern amongst audit committees was that choice was further constrained by existing regulations governing auditor independence, particularly when considering the provision of non-audit services.

This problem is exacerbated by the increased statutory and market focus on ensuring independence is safeguarded and not threatened by the provision of non-audit services by the external auditor to the audit client.

Typically, large companies turn to Big Four firms for complex, cross-border non-audit services, which can then preclude such firms from becoming the auditor of these companies for a period of time at least.

In addition, the financial services sector is subject to even stricter independence rules regarding banking, insurance and pension arrangements for example.

We strongly support the principle of auditors being, and being seen to be, independent in their role, but it must be noted that this is not an end to itself, rather a means of enhancing audit quality or perceived audit quality. We believe that a review of the current independence code should be carried out in consultation with the corporate and investor community. This review should focus on those elements of the independence code that do not play a part in enhancing audit quality. It should recognise that many immaterial financial relationships that are currently forbidden do not in fact impact on independence. Above all, the review should recognise the need for a consistent global approach to independence.

3.4.3 Access to previous auditors files

A significant cost in changing auditors is the “learning curve” experienced by the new auditor as a sound understanding of the client’s business is sought in the first year. This typically involves many meetings with senior management and discussions internally with those with industry experience.

Currently, there is no obligation on an outgoing auditor to allow the incoming auditor access to the audit files of the previous auditor. Accordingly, the new auditor has to spend additional time in the first year gaining an understanding of the client’s business and determining the key audit and business risks and satisfying itself in relation to opening balances.



If the new auditor had access to the previous auditor's audit files, a much quicker understanding of the key audit issues that are likely to require attention could be gained. This would not absolve the new auditor from performing a thorough audit but should facilitate a smoother handover process resulting in lower costs associated with such a handover.

Appropriate safeguards would need to be put in place for the outgoing auditor in respect of the access to these files. Similar "hold harmless" procedures already exist in transaction services engagements and could be extended to cover audits also.

4 Losing another Big Four firm

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

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. (Examples omitted.)

4.1 Reducing the risk of a firm leaving the market

A major firm is only likely to leave the market as a result of catastrophic litigation or significant damage to reputation with resultant loss of clients probably as a result of some form of regulatory action.

The loss of a major firm within a network would significantly affect all the network firms around the globe and would be likely to lead to the collapse of our network as a whole.

The remaining firms both within the network of the collapsed firm and within other large firms' networks would undoubtedly seriously consider the ramifications of that firm's exit in particular with regard to the risks associated with remaining in the audit market depending on the circumstances surrounding the other firms exit. It is possible that, depending on those circumstances, the remaining large firms may consider withdrawing from the large, multi-national listed company audit market altogether.

Recent developments in the UK on auditor liability and audit quality have as a long term objective the reduction in the risk of a firm leaving the market.

4.1.1 Auditor liability

The expected introduction of limited liability for auditors in the UK, through the Company Law Bill is welcomed by the auditing profession and the corporate and investor communities as a measured response to increasing globalisation and rising values of claims made against auditing firms.

A regime that ensures that auditors are held accountable only for their own acts and not the acts of others is fair and just.

Previously, auditors were seen as the insurer of last resort, with deep pockets backed by professional insurance policies, in cases where damages were awarded to those who had suffered loss.

As globalisation gathered pace and clients grew in size, so did the size of claims against auditors and, as a result, commercial insurers withdrew from providing professional indemnity insurance for the large audit firms.

Consequently, the Big Four firms were forced to set up their own captive insurance vehicles, which, over time, have required a significant level of capital to cover potential claims.

Despite the existence of these captive insurance vehicles, we do not have sufficient capital to deal with a single catastrophic claim or indeed from a series of lesser claims.

The introduction of auditor liability will hopefully encourage the commercial insurance markets to re-enter the professional indemnity insurance market for auditors. This would encourage non-Big Four firms to compete in the large company audit market without the need for significant capital funding to cover potential claims.

This matter is of particular importance from a global perspective and the UK is following in many other countries footsteps, both in Europe and on other continents. Auditor liability is currently the subject on an independent study in Europe, commissioned by the European Commission³, and we hope to see this matter being debated in the US in the near future. In this context, we are pleased to note support for liability reform from important independent bodies in the US such as the US Chamber of Commerce and the American Assembly.

Given the global nature of the Big Four, it is critical for auditor liability to be effective in all significant territories.

4.1.2 Commitment to audit quality

KPMG is committed to audit quality as a core element of our business strategy.

We welcome independent oversight from the FRC and engage fully in the comments and recommendations that follow AIU inspections. Given that we have only recently completed the second round of investigations, further time is needed to fully embed the recommendations of the AIU into our policies and procedures.

We will continue to consistently review our practices and update our audit methodologies where appropriate to keep pace with changing market conditions.

We are aware that the FRC is currently undertaking a project to identify the drivers of audit quality and we look forward to playing an active part in this project.

4.1.3 Effective dialogue amongst stakeholders

In circumstances where there has been a major corporate collapse, it is vital that the corporate and investor communities are kept as well informed as possible as quickly as possible to ensure that any subsequent decisions taken are done so with full and accurate information.

³ Study on the Economic Impact of Auditors' Liability Regimes, London Economics, July 2006

In the case of Enron, the premature criminal indictment of the audit firm Andersen by US regulators triggered a reaction from its global clients to seek alternative auditors on a global basis.

This effectively caused the splintering of Andersen's global network, both clients and personnel to the remaining Big Four firms around the globe. This domino effect and the rate at which it can gather should not be underestimated and advance planning in dealing with such an event is highly recommended. It is important that global regulators work together to develop protocols for dealing with situations such as Enron in a measured fashion to ensure that we do not have another unnecessary collapse.

In the event of a similar corporate collapse in the future, it is vital that all parties and stakeholders involved react in a timely but measured manner to ensure that all facts of the matter are fully known and communicated effectively to enable balanced views to be formed and appropriate decisions to be taken.

4.2 Reducing uncertainty and disruption costs

4.2.1 Client transition process

It is likely that the largest companies and those with significant overseas operations would seek one of the remaining three large audit firms for the reasons identified in Oxera's report.

The loss of a Big Four firm will further concentrate the large company audit market, particularly so where the firm concerned had significant expertise in one or more industries. Therefore it is less likely that the entire client base of the affected firm would move en masse to one of the remaining firms.

Given the current focus on concentration and choice in the large company audit market, a splintering of clients to the most appropriate audit firms appears more likely.

Any attempts by regulators to direct the transition of clients from the failed firm to new auditors, would need to be done with the best interests of all stakeholders in mind, and in compliance with existing corporate governance requirements regarding selection of auditors.

Companies may also need to change auditors in a relatively short period of time depending on external reporting requirements. Regulators may need to consider a relaxing of certain external reporting requirements in such circumstances.

4.2.2 People transition process

The redeployment of affected staff would likely follow the flow of clients. Audit firms do not typically operate with sufficient resource capacity to take on a significant level of new clients without the need for additional personnel resource.

The loss of a Big Four firm will have significant implications for many thousands of people. As the client transition process takes shape and firms assess their additional

resource needs, regulators will need to maintain a dialogue with both the corporate community and audit firms to assess the situation and consider whether a temporary relaxing of existing regulations affecting either companies (such as reporting deadlines) or audit firms (regulatory inspections or follow-up procedures) would assist the transition process.

4.2.3 **Effective dialogue amongst stakeholders**

The loss of a Big Four audit firm is likely to have a significant impact on the global capital markets. The investor community will understandably be concerned about the impact of this loss on the listed audit market.

Throughout the transition process it will be incumbent on all stakeholders (regulators, audit firms, companies and investors) to maintain an open dialogue to ensure all relevant information is shared as needed to ensure the long term stability of the capital markets. Clearly the financial media will also have a significant role to play in this process.

Major regulators with overall responsibility for the long term stability of the global capital markets, should take the lead in ensuring that this effective dialogue takes place if the circumstances arise in the future.

5 Conclusions

We consider that the key issue in this debate is around choice and not competition, price or audit quality, and then only for the very largest multinational companies rather than the listed market as a whole. We do not consider the current position as untenable, although we recognise the desire for more choice on the part of many stakeholders.

With reputation being a key driver of choice, we encourage the provision of appropriate information to audit committees to enable them to make an informed choice on selection and retention of auditors and to comply with corporate governance regulations.

We welcome any actions that reduce the current barriers to entry, such as the expected introduction of limitation of auditor liability, which should encourage the availability of commercial insurance and the relaxation of current independence regulations.

We do not consider that regulatory intervention such as break up of the existing largest networks or compulsory firm rotation or mandatory tendering would resolve the current situation. It would, in fact, increase costs and would be unlikely to reduce current levels of concentration. It is also likely to reduce audit quality. It is important, therefore, that a thorough regulatory impact assessment is carried out in respect of any regulatory intervention that is contemplated.

In addition, we cannot see how any intervention or solution would operate on a UK stand alone basis in a way that would create more choice for those clients needing a consistent global audit service.

In summary, we favour allowing the market to identify the appropriate solution and would encourage major regulators with overall responsibility for the long term stability of the global capital markets to take the lead in ensuring that a market-based solution is arrived at for this global issue. Any solution must be judged against its ability to improve audit quality which is the most important requirement as far as the global capital markets are concerned.