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CHOICE IN THE UK AUDIT MARKET

I am writing on behalf of Morley Fund Management in response to the FRC's Discussion Paper: 'Choice in the UK Audit Market' (May 2006).

Morley is the global investment business of Aviva plc, the world's sixth largest insurance group, and manages over £156 billion in funds with around 82% of that currently committed to Europe.

We welcome the current debate on competition and choice and support the need for this debate. As the FRC's current Discussion Paper notes: "Given the importance of audit, we consider that any risks to the effectiveness of the market for audit services should be the subject of public debate" and that "the public debate should consider the: nature of any risks arising from the characteristics of the audit market..". We agree.

While we acknowledge that in the current context the relevant powers of the competition authorities are not being brought to bear, that does underline the importance of having a full and effective debate. In that context, we consider the emphasis given in the Discussion Paper to the supply aspect of 'choice' to be too limiting and that should not be the primary focus and driver of the debate. As an institutional shareholder we consider the key driver and benefit that needs to be pursued in debating competition and choice, to be audit quality. As part of that, greater transparency and visibility of audit quality and of audit outputs will be key.

In addition, alongside identifying what immediate practical actions might be pursued, there would also be merit in seeking a debate on more fundamental, conceptual questions such as: whether the current form of the audit still adds value and warrants the costs it imposes? What alternative forms of safeguard/assurance for the whole listed company market might warrant consideration? Whether a move back towards purposive, output based principles rather than defensive, input based standards is needed? What options might be considered to re-enfranchise shareholders and empower them to be more actively involved in the oversight of the audit and auditor selection?

In the context of the above, we have provided some brief comments on the specific questions highlighted in the Discussion Paper:

Q.1 Do you agree that the focus of the debate should be on the degree of choice in the market for audit services to large public companies, rather than other features of this market?

Given the emphasis and focus that the Discussion Paper gives to what is in effect the question of supply, we cannot agree with the proposition as presented. For a debate on competition and choice to be truly effective and for the aspirations in the Discussion Paper (noted above) to be met, the debate and ongoing deliberations need to be widened to address, amongst other things:

- **Choice of offering/service:** is there now a need to question the level of choice in or scope to differentiate the audit offerings? Does a uniform offering based around rigid compliance with IFAC standards hinder the depth and scope of competition and create barriers to entry? As we have previously noted in our paper "Bringing Audit Back From The Brink: Auditor liability and the need to overhaul a key investor protection framework" (2004), the applicability of the Akerlof Model (Market for Lemons) is certainly feasible and not without reason. Consideration still needs to be given to the effect of increasingly defensive, compliance orientated standards that have been developed by the global firms through IFAC. Do they in fact lead to lower quality audit opinions and create a dynamic that forces high quality audit opinions out of the market? A market where:

"...honest auditors are unable to compete in [the] market unless they decrease the quality of their own audit or supplement their (lack of) audit income with other revenue streams (e.g. non-audit services, which results in undermining auditors' independence."

"Audit Opinions or Lemons? Insights from Andersen and the Enron Audit" P.Roush and L.Thorne, University of Central Florida and York University Ontario

- **Quality of audit offerings:** what will get suppliers focused on quality of the audit as the key for differentiation and competition? Again, as we have previously pointed out, academic work by has underlined the concern that the combined effect of concentration in the Big firms and the nature of regulation itself, has effectively contributed to preventing companies from utilising smaller accounting firms. This operates against the public interest in that it has reduced competition and the big accounting firms' incentives to differentiate their audit product on the basis of quality:

"The modern accounting industry operates more like a business than a profession. The decline in professionalism is a problem that goes beyond Enron, Worldcom and other recent corporate scandals. The problem is deeper than the concerns about the simultaneous provision of audit services and consulting..... the internal corporate governance structure of the big accounting firms is fundamentally flawed.... The incentive structure within accounting firms makes it virtually impossible for auditors to be independent of significant clients like Enron. This flaw has led to a gradual, but fundamental, change in the basic balance of economic power between accounting firms and their audit clients."

J.Macey and H.Sale, Professors at Cornell Law School and the University of Iowa College of Law respectively ("Observations on the Role of Commodification, Independence and Governance in the Accounting Industry" (Nov 2003) Villanova Public Law and Legal Theory Working Paper No. 2003-18)

- **Innovation:** Has concentration in the audit market and the global firms' role in developing and rolling out audit standards stifled innovation? Does this hinder

innovation by entrenching the business model of the large firms? How can that be changed? It has been repeatedly suggested by representatives of the Big 4 that the current market structure does not create any substantial problems, implicitly suggesting that the current situation is tantamount to a natural monopoly in professional audit services. Is this truly a market of a basic scale-utility? Such suggestions warrant caution and merit being questioned.

- **Price:** finally, how do you break any barriers to a healthy market that allows effective (economic) pricing (i.e. not just lowest cost) built on the first three bullet points above. Within reason, the priority and main interest for investors is quality and that is equally the main source of concern about the audit market.

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?

It will be important for regulators and policy makers to ensure that their policies are not tilted towards the business model of the large firms. This means recognising the role of medium-sized firms and consciously engaging them in the regulatory debate. In addition, the greater the potential risk of regulatory capture, the more assiduously that must be guarded against.

We would suggest that qualitative criteria, along the following lines, be applied in assessing proposals for reform:

Positive criteria (characteristics that should be looked for)

- Does it improve the quality, and the visibility and transparency of the quality, of audits?
- Does it improve the scope for innovation in the audit offering and outputs for beneficiaries?
- Does it encourage competition and choice based on quality of the audit offering?
- Does it encourage competitive pricing differentiation?
- Does it increase scope for non-Big 4 firms to increase their involvement in the market?
- Does it increase accountability to and focus on shareholders and help protect their ownership interest?
- Does it facilitate the use of a full range of regulatory sanctions against audit firms or practitioners that fail to carry out their duties properly?

Negative criteria (characteristics that should be avoided)

- Does it further immunize auditors from responsibility and accountability for failures?
- Does it help consolidate either local, regional or international oligopolies?
- Does it risk creating barriers to entry or other hazards, e.g. by creating a two tier market where large companies are subject to a 'full' audit while smaller companies are subject to a 'quasi' audit/reasonable assurance engagement?
- Does it or might it limit or inhibit any future intervention by the proper competition or regulatory authorities (e.g. allowing firms to become single global entities).
- Does it disenfranchise shareholders or distance auditors from them?
- Does it subordinate the audit to the Directors of the company, whose stewardship (internal controls/accounting records and financial reporting) they are supposed to be providing an independent check on.

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

The single most significant step that could be taken by regulators and policy makers in this respect would be to begin a study of the options that could be used to introduce greater shareholder involvement in the selection, appointment and oversight of the auditor. As outlined in our paper "Audit Reform: a focus on purpose and transparency" (Dec 2004) some of the options for this that could be useful be examined include:

- (i) Drawing on other European country's experience, e.g. from Sweden, shareholders representing at least ten percent of the issued shares, or one-third of the shares represented at a general meeting, can move that a special auditor be appointed;
- (ii) Again Drawing on other European country's experience, developing auditor selection and appointment by a separately constituted shareholder panels that are nominated and approved by shareholders at an annual general meeting (developing systems that can be found in countries like France or Spain);
- (iii) As a variant of (ii) rather than company specific shareholder panels, a shareholder organization/mutual might be established to oversee and 'own' audits; or
- (iv) Auditors being appointed by an independent regulator along the lines of the Audit Commission's role in the Local Authority market.

In this context, there would be merit in this context of an examination of the Audit Commission's role and experience in facilitating both competition and quality in the Local Authority audit market.

The existence and effect of any parallel restrictions that can restrict competition and choice should be investigated, for example the terms of loan/debt covenants.

We are aware that proposals have been mooted to allow audit firms greater access to external capital. We would urge caution on this. Offering scope to raise additional capital could lead to un-intended consequences, particularly if it were to unduly benefit the Big 4 firms. Equally it might exacerbate the existing concern over the current business models and revenue generation priority of the firms, at the expense of audit quality considerations.

This may well link to the desire, highlighted by Big4 representatives, to consolidate the large audit firms into single global firms or companies. Aside from any potential for entrenching the Big4, such moves may also risk frustrating and further limiting the scope for and effectiveness of future regulatory action or intervention.

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.

While the debate over audit partner rotation versus firm rotation clearly favoured the former, that debate was focussed on the short term (5 to 7 years). There would be merit in considering the question of whether, in a longer-term context, an outer limit should be set, say 12 years, after which audit firm rotation or at very least (and over a slightly shorter period) mandatory tendering would be required.

If the market is to be opened up to greater competition the situation identified by Oxera, where switching rates are low (around 4% on average for all listed companies, 2% on average for FTSE 100 companies) and where competitive tendering does not occur frequently, must change. In extremis, the lack of an outer limit can lead to some truly impressive relationships, such as that of PwC with RadioShack, where the firm and its predecessors are reported to have been the auditor since 1899.

Clearly there is also a need for a change in the perception of what institutional shareholders would welcome. We, along with other institutional shareholders, have written to many audit committee chairmen to make clear that we would welcome more companies in which we invest accessing the skills and capabilities of the next tier of audit firms. As things stand the challenge now is for audit committees to, at least, ensure proper inclusion of non-Big 4 audit firms when the audit is put out to tender.

Alongside this, we see considerable merit in the suggestion that best practice guidance for audit committees on tendering and selection of audit contracts should be developed.

Standard setters should also act to close the current gaps in the regulatory framework that allow for the provision of non-audit services including, in particular, the provision of tax advisory services that have raised clear moral hazard concerns (re: tax avoidance/shelters) and scope for subsequent self-review conflicts. The focus on non-audit interests taking precedence over the audit, that keeps emerging, needs to be challenged. When senior practitioners go on the record, as one UK senior partner at PwC did, and make clear that their firm had sought assurances from prospective audit clients that they would be prepared to give it consulting or else the firm would “think long and hard” before being prepared to pitch for the audit, there must be a concern.

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.**

Alongside seeking an overarching objective of seeking create visibility and transparency in audit quality, the most significant steps would be:

1. (longer-term) likely to arise from proposals that emerged from a debate on mechanisms for greater shareholder involvement in the selection, appointment and oversight of the auditors. Such an approach offers the potential to deliver a significant change in the market as has been seen in the Audit Commission's latest award of new contracts for audit services announced on 25 July 2006.
2. The introduction of an outside limit (e.g. 12 years) after which an audit firm should be rotated or put out to tender.
3. The introduction of a requirement for companies to appoint an alternate auditor (as a contingency) to provide cover should the main

auditor, for whatever reason, be unable to continue to audit the company.

4. Encouraging, both through consensus and best practice guidance, the active consideration of non-Big4 firms in competitive tenders.
5. A tightening up in the restrictions on non-audit service, in particular on the provision of tax advisory work to audit clients.
6. Identifying and removing other restrictions on selection of auditors, e.g. in loan/debt covenants.
7. The publication of individual firm reports by the POBA's Audit Inspection Unit along similar lines to the US PCAOB, increasing transparency and visibility and providing a focus on driving up standards and better practice.
8. An independent, objective review of the effects of the standards and related processes and business models developed by the global firms in directly, or indirectly, hinder competition.

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

We endorse the ABI's view that Audit firms can protect themselves by ensuring that the work they produce is of high quality and that they thereby protect themselves against unnecessary risk. Andersen's withdrawal came about as a result of loss of confidence among its clients following some elementary internal breaches of sound practice. Equally, the culture where top level interventions suppresses problems being highlighted by practitioners at the coal face, to keep 'clients' happy (e.g. in the Parmalat case) illustrate the point.

Despite the focus that has been given to further auditor liability reform, we do not consider that to be the right way to proceed. Indeed catastrophic liability risk has never been a tangible problem in the UK, being more a spectre raised by determined PR than by a real threat. The one time the existing proportionate liability arrangements have needed to be tested in full (in the Barings case), they have proven to be extremely powerful in protecting and limiting the liability of the auditor.

Further limitation of liability provides no incentive to quality and may indeed encourage auditors to cut corners and take risks. A considerable body of academic work on the effects of the legislative reforms that introduced proportionate liability in the US highlight links between such reforms and perceived decreases in audit quality and practice. An equivalent effect might be expected in the UK, particularly given the marked lack of off-setting audit quality reforms that have been progressed.

Amongst the trends that have been highlighted, which shareholders would be concerned to see replicated in the UK include:

- Evidence of more earnings management in companies audited by the large firms (e.g. Levitt (1998) or Lee and Mande (2003));
- Fewer going-concern qualifications (Francis and Krishnan (2002));
- Reduced audit work and effort (Chan and Pae (1998) or Zeff (2003b));
- Increasing use of shortcuts (Otley & Pierce (1996)); and
- The speeding up of testing (Willett & Page (1996)).

In addition, there is no tangible evidence that liability limitation will add to choice by encouraging additional entrants to the market, although concerns about regulatory

capture have arisen, as seen in the reactions to the KPMG tax case and moves by Japanese regulators to address unacceptable audit firm practices.

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.

Consideration could be given to adapting the existing French system of appointing alternate auditors. This might provide regulators with some comfort if it were used to ensure companies had contingency arrangements in place should their audit firm withdraw or be suspended/banned by the regulatory authorities.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Iain Richards', with a horizontal line underneath the name.

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