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Dear Mr Rose

Choice in the UK Audit Market

The Business Law Committee is the Institute's committee which monitors developments in the rules and regulations affecting businesses generally and considers legislative and other proposals deriving from bodies such as the DTI, the European Commission and the UK Listing Authority. The Committee is broadly based, with members representing different sizes of accountancy practice, industry, the investment community, and the legal profession.

Summary

The FRC discussion paper 'Choice in the UK Audit Market' indicates that its purpose is to facilitate public debate on how to respond appropriately to the findings in the Oxera study. The Business Law Committee holds the view that the study was largely factual and reflects a position concerning choice in the UK audit market that has existed in recent years.

We believe that the effective degree of choice available to listed companies is now wider than is sometimes perceived and that there is currently no issue of such concern as to require active intervention in the market by regulators or government in the UK. This change is due to market forces and the impact of recent structural changes (such as the Smith Guidance for Audit Committees), and choice in the UK audit market should continue to be dictated by these forces.

We believe that there could be no feasible intervention by the FRC to ensure the Big 4 stay in the listed company audit market, and it is not practicable to coerce other audit firms to enter this particular market. The FRC may wish to monitor choice over the next few years but we do not think that any active intervention would be helpful at this stage. We expand upon our views below.

In order to help inform our response we conducted a survey amongst Audit Committee Chairmen of the companies in the FTSE 350 list. The survey was issued in early June 2006 and the response rate was 14%. We attach the findings from the survey as an appendix to this letter. In summary, in relation to the current state of the audit market for listed companies, three quarters of respondents believe that the FRC should take no immediate action and leave the matter to market forces, with a third of these supporting the possibility of a review in a few years time.

General points

The phraseology in Paragraph 7 of the paper, which discusses key findings of the Oxera study, is both unusual and emotive. It says that the audit product provides ‘comfort that the auditor is capable of detecting accounting irregularities and instances of fraud, thus preventing accounting catastrophes;...’. This misrepresents the ability of the auditor to detect irregularities and fraud, and perpetuates the expectation gap relating to audit whose focus is to consider whether accounts show a true and fair view. An audit is historical and, therefore, is not expressly designed to prevent future accounting scandals.

Paragraph 7 also covers the practice whereby audit committees put appropriate safeguards in place by appointing an auditor with a well established reputation. We consider that whilst an element of the audit is to provide assurance, the ‘insurance’ and reputational aspect on its own is overplayed in the Oxera report. More important are the factors of geographic service capability, expertise (especially in specialised industries) and quality, all of which support reputation.

The report emphasises, and probably exaggerates, the differences in qualitative terms between the Big 4 and other audit firms in the context of the work they actually undertake. For example, Group A firms perform similar audit work to the Big 4 auditors but with a slightly different client base. Furthermore, the Group A firms continue to provide a range of non-audit services to the FTSE 350 companies.

Specific questions in the discussion paper

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?

As indicated above the focus of the debate should be on more than just choice, because one should not examine each factor in isolation. Other important factors in appointing an auditor are quality and service capability. Isolating one factor and attempting to change it, may have undesirable consequences in other areas; for example, ‘encouraging’ greater choice could impact on quality if an audit firm without an international network tried to service a global business. A number of the comments in our survey indicate that both geographical coverage and relevant experience of auditing international companies are important elements in choosing an auditor. In terms of choice, the majority of respondents in our survey consider that tendering for audit services over the period 2006 to 2010 compared with 2001 to 2005 will be more likely, suggesting a willingness by companies to consider other auditors.

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?

We have no particular comments in relation to this question.

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 markets for audits of large companies.

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.

In response to both questions 3 and 4 the view of the Committee is that FTSE 350 companies are increasingly willing to appoint non-Big 4 firms to supply a range of non-audit services, but generally not

the audit itself. In our view, multinational companies feel they need a Big 4 auditor to ensure an effective, cost efficient audit with the same audit approach and quality standards in all jurisdictions. Other firms, without the same 'critical mass' may not be seen as having the same global coverage and expertise.

We believe that each firm has its own clearly defined market and it is unrealistic to expect most audit firms to compete for multinational audits. Similarly, one would expect a small, one–two partner firm to have its own niche market based on, say, a specific geographical area or particular business sector. Other firms may specialise in particular types of work such as pensions, corporate finance, tax or charities. Even with the global audit market limited to the Big 4, for most companies this does provide sufficient choice, although we recognise that there are pockets of industry where the choice is more limited, notably so in parts of the financial sector.

According to the majority of the respondents in our survey, the implementation of the Smith Guidance on audit committees is unlikely to lead to change in the future in the appointment of mid-tier/non-Big 4 firms as auditors. However a significant proportion, 37%, think that there is more likely to be a change towards the non-Big 4 in the provision of non-audit services.

In summary, we question whether it would be effective or practicable, even if in some cases it might appear desirable, to intervene at present to encourage the purchase of audit services from non-Big 4 firms. We would, however, advocate the encouragement of a greater emphasis on principles rather than rules because it seems to us that the complexity of current accounting rules, in both accounting and auditing, means that work gravitates to those with more resources to invest in tracking, interpreting, and monitoring those rules. An approach focussed more on principles should be more accessible.

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.**

The distinction between audit and non-audit services, and what non-audit work the auditor can undertake, can have an impact on audit choice. Each audit firm is bound by APB Ethical Standards regarding what non-audit services it can provide, but company audit committees tend to set their own rules, some more conservatively than others. Arguably, if the audit firm is not allowed to tender for non-audit work (which may involve considerable input and could provide income for the firm) then there may be little incentive to bid for the audit. We believe that this was the case some years ago but that the lack of choice of auditor has led to audit committees reconsidering the restrictions on non-audit services provided by the audit firm. Consequently, we believe the Big 4 are now more willing to bid for audits and so choice has increased.

We would not welcome any encouragement of compulsory audit firm rotation. In our experience such an exercise is extremely time consuming and expensive, for both parties, and this discourages companies from changing audit firms. The key to appointing an auditor is for the audit committee to be comfortable with the audit partner and key audit staff. Whilst the Committee accepts the purpose of audit partner rotation and believes that partner rotation is effective in its current form, it would not agree with any proposal for regular audit firm rotation.

Our survey indicates that in order for listed companies to consider appointing a mid-tier/non-Big 4 firm as auditors, there would need to be a change in attitude by boards of directors, audit committees and institutional shareholders.

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

The scale and speed of the collapse of Andersen has acted as a warning of how quickly a professional firm, where much depends on reputation, can disappear. Good reputation is vital and audit partners are well aware of this, and they will do all they can to maintain and enhance it, without the need for external support or regulation. It is important, however, that measures are not adopted that may unjustly weaken a reputation. We disagree, for example, with 'name and shame' type measures where a one-off instance of a problem or issue can be portrayed or interpreted as a more fundamental problem with a firm and can be unnecessarily destructive. The key to audit monitoring and, where necessary, improving audit practices, rests upon effective cooperation between the profession and the regulator.

The overall value of an audit is built on quality, service capability, value for money and professionalism. Audit monitoring by both the independent Audit Inspection Unit and by professional institutes seeks to maintain audit quality, but beyond this we would not wish to see any member firm being retained in a sector simply to provide choice.

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.

We believe that choice in the audit market is gradually increasing and continues to do so, and that there is no practicable regulatory intervention which could be undertaken to increase choice by artificial means. We believe that choice in the UK audit market should continue to be governed by market forces. There could be no feasible intervention by the FRC to ensure the Big 4 stay in the listed company audit market, and it is not practicable to coerce other audit firms to enter this particular market. The FRC may wish to monitor choice over the next few years but we do not believe that active intervention would be helpful at this stage.

Please do not hesitate to contact me should you wish to discuss any of the above points.

Yours sincerely

Charlotte M Barbour
Assistant Director
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APPENDIX
RESULTS OF QUESTIONNAIRE ON LIKELY TRENDS ON COMPETITION AND CHOICE IN THE UK AUDIT MARKET

Results based on 49 responses received out of 350 questionnaires issued (14% response rate)

1. Do you consider that tendering for audit services over the period 2006 to 2010 compared with 2001 to 2005 will be:

More likely	57%
No change	37%
Less likely	4%
No response	2%

2. Do you think that the implementation of the (Smith) Guidance on Audit Committees included in the Combined Code from 2003 will make the appointment of mid-tier/non-Big 4 firms as (a) listed companies' auditors and (b) providers of non-audit services in the future:

(a) Auditors:	More likely	8%
	No change	65%
	Less likely	27%

(b) Providers of Non-audit Services	More likely	37%
	No change	53%
	Less likely	8%
	No response	2%

3. Do you think that the increasing familiarisation with mid-tier/non-Big 4 firms, e.g. through their use for non-audit services (such as IFRS implementation, Sarbanes Oxley work etc) will make the appointment of mid-tier/non-Big 4 firms as listed companies' auditors in the future:

More likely	29%
No change	65%
Less likely	4%
Doesn't think there is increased familiarisation	2%

4. For listed companies to consider appointing a mid-tier/non-Big 4 firm as auditors, which parties would need to signal change from their current attitude:

	Moderate Change
Boards of directors	65%
Audit committees	63%
Institutional shareholders	45%
Investor representative organisations (NAPF, ABI, PIRC etc)	29%
Regulatory bodies (where appropriate)	12%
FSA (as UK Listing Authority)	14%
Mid-tier / non-Big 4 firm	31%
Others – Providers of debt	2%

	Some Change
Boards of directors	24%
Audit committees	22%
Institutional shareholders	37%
Investor representative organisations (NAPF, ABI, PIRC etc)	35%
Regulatory bodies (where appropriate)	27%
FSA (as UK Listing Authority)	24%
Mid-tier / non-Big 4 firm	29%
Others	0

	No Change
Boards of directors	4%
Audit committees	4%
Institutional shareholders	8%
Investor representative organisations (NAPF, ABI, PIRC etc)	20%
Regulatory bodies (where appropriate)	43%
FSA (as UK Listing Authority)	43%
Mid-tier / non-Big 4 firm	18%
Others – Various	10%

5. In relation to the state of the audit market for listed companies, do you believe that the FRC should:

Take immediate action to seek to broaden the audit market for listed companies	24.5%
Allow recent changes to take effect and review the situation in a few years time	24.5%
Take no action at all, and leave this matter to market forces	51%

6. Do you have any other comments on the state of the audit market for listed companies, or measures which might increase company choice of auditor?

Comments Received

- For international companies the international reach of auditors is important. The most important issue is to thoroughly review objectively the performance of the auditors annually.
- I believe the major obstacle for non-Big 4 firms to win FTSE 350 audits will be their geographic coverage. Most large companies are now international in their operations and are therefore seeking audit firms who have a significant presence to audit subsidiary companies. In my view the non-Big 4 firms who cover the territory with associate relationship will not be considered due to the issues of consistency and quality of work. On the other hand non-Big 4 firms are now much better placed to carry out non-audit services provided they are able to demonstrate high quality expertise in relevant areas.
- The reputation and professionalism of mid-tier firms needs to be raised considerably with chairman of major plcs.
- I think it is most unlikely that the mid-tier will penetrate this market. Their recruits are less well qualified, their training is lower quality, and most importantly they do not have the clients to enable their partners and staff to obtain appropriate experience.
- Not a good environment for audit committees - too little real choice and pricing has risen significantly due to oligopoly. Smaller auditors lack breadth and perceived to be too high risk.
- There is an element of protection in using a Big 4 firm. However it, in my opinion, is more to do with scale, and the more effective spreading of overhead/learning/systems costs which happens with the larger firms. Amalgamations (successful!) of firms to make a Big 5 or 6 would be a good way forward if it could be executed successfully.
- As audit firms re-enter consulting aggressively, public confidence is likely to decline when the next 'scandal' happens. On competition grounds, there needs to be price transparency between regulated (i.e. audit etc) and non-regulated (e.g. tax, consulting) services. Audit firms need a regulator like the utilities or BBC in the public interest.

- I do not see how changes in the regulatory environment will have a significant effect on the audit services market. I believe there is ample competition between the Big 4 but too little choice. For a mid-tier firm to be seriously considered for an international group it will have to change radically to promise the depth and coverage required.
- At least one mid-tier firm has stated that it does not want to provide external audit work to large businesses.

Mid-tier accounting businesses need to demonstrate their capability to exceed the expectations of investors and for this confidence to then be communicated to plc boards. Mid-tier capacity does not seem to exist for any major shift to the use by plcs from Big 4 to mid-tier. Plc boards have needed to address a raft of new legislation and regulatory frameworks including IFRS, IAS, and for this to be taken seriously and embedded it will take time. Consequently it would be better not to further compound the problems being experienced at this stage with any significant new requirements.

One of the crucial areas for larger, multi national plcs is in the area of tax management. As this increases in complexity (coupled with moves away from external auditors providing such consulting advice) so the need to use other specialists will grow.

- Recent tender included mid-tier (not successful).
- It would be preferable to have two more firms with integrated international networks and could therefore provide realistic alternatives to the Big 4 for companies with operations in many countries.
- My experience is that with the audit firms I work with (through the three companies I am involved with) audit quality is high. Non-Big 4 firms do not in my experience wish to pitch for the audits but will do for non-audit work – and are frequently successful in achieving it!- What does this tell me about non-Big 4's attitude to doing business with large corporates?!!
- The mid-tier just cannot compete because the quality of the student intake is lower and they cannot provide experience of auditing large complex companies. If you cannot spend most of your training in complex companies you cannot safely be asked to audit them later in your career.