

FRC Discussion Paper: Choice in the UK Audit Market

A response by

The National Association of Pension Funds

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Introduction

The NAPF is the leading voice of workplace pension provision in the UK. Some 10 million working people are currently in NAPF Member schemes, while around 5 million pensioners are receiving valuable retirement income from such schemes. NAPF Member schemes hold assets of around £800bn, and account for over approximately one fifth of investment in the UK stock market.

The NAPF welcomes the opportunity to comment on the consultation.

Pre-amble

The NAPF is attracted by the suggestion put forward by Governance for Owners that the Combined Code be amended to require a shareholder vote on the report of the Audit Committee. This is intended to reinforce the link between shareholders and the audit committee (as the board representatives of shareholders on audit matters). This suggestion would not be dissimilar to the vote on the remuneration committee report which is widely regarded as having been a success. NAPF supports the idea in principle but would welcome a wider debate on the proposal, its scope and likely merits/demerits.

The NAPF's replies to the individual questions posed in the discussion paper are as follows:

- 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?*
 - a) It is already becoming difficult to find independent advice in merger & acquisition activity, especially when a pension fund also needs independent advice – something that is increasingly expected following the Pensions Act 2004. Therefore NAPF would be very concerned if, for whatever reason, the “Big Four” were to become “Three”. The reality in such a situation is that the position would be untenable if effective choice were limited to three firms.
 - b) We recognise that many companies prefer a “one-stop-shop” and are encouraged by investors to use the large firms, whose reputation provides considerable comfort to them. Companies are expected to put non-audit work out to tender, but to date this does

not appear to have led to much diversification of appointments and has had no discernable impact on the market for audit services.

- c) In NAPF's view the focus of the debate should be on the risks arising from the concentration of the market and how to mitigate those risks.

2) *What do you regard as the most important criteria for evaluating any opportunities for mitigating risk arising from the level of choice in the audit market?*

- a) From the investor perspective, the key elements are integrity of process and transparency in reporting.
- b) Companies' audit committees should have a fuller public discussion of the steps which they have taken to mitigate auditor risk in the Annual Report and Accounts, including an explanation, where they change auditors within the Big Four, of why they have chosen **not** to make an appointment from outside the Big Four.
- c) The audit quality discussions are very important in helping to define integrity of process. Several investors have publicly expressed their concerns about what they perceive as a real threat to the quality of the audit in the UK. Whilst some regard their position as extreme, there can be little doubt that the trend is as they suggest. The judgemental element of the UK audit should not be lost in an attempt to mitigate risk.

3) *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.*

- a) See above on the role of the audit committee.
- b) Investor interest in this area has, with a few exceptions, been lacking and if anything the tendency is to encourage use of the Big Four. There is a real challenge in changing investors' attitude to auditor risk.

4) *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.*

- a) Any impediments to change should be removed. In particular, investors should look on a change in auditor as being a positive move and not, as is too often the case, a sign of fundamental disagreement between auditor and client.
- b) As noted above much of the onus for developing a more transparent market rests with audit committees, encouraged by their shareholders.

- c) Shareholders should seek better explanations of the tender and re-tender process and support change when justified. It is not their role to provide support in the evaluation process itself.

5) *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.*

- a) As noted earlier we do not see choice as being the key issue. The barriers to entry are consumer preference, reputation of the Big Four and capital/resources among other firms. This last point would be addressed if market participants perceived there to be a profitable opportunity for them.
- b) An important issue for all audit firms, but one that is likely to be proportionally greater to firms outside the Big Four, is the question of liability. The liability issue is currently being addressed as the new Company Law Bill proceeds through Parliament. Hopefully by establishing a fairer liability regime for shareholders, companies and audit firms this barrier will be reduced.

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

- a) We view this as being very important, not because there may be less capacity available (the Anderson demise suggests that this is not the issue because the Anderson capacity simply became available elsewhere in the market as individual practitioners relocated) but because, with only three firms dominating the industry, there would be a real competition issue. M & A activity increases the problem of securing independent advice for companies and their pension funds as explained above. NAPF would expect that any such reduction in the Big Four, leading to further concentration in the audit market, would attract an investigation by the Competition Commission.
- b) Audit committees should have contingency plans for such an eventuality, just as they would deal with any other risks.

7) *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*

See 6) above