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Dear Julian

CHOICE IN THE UK AUDIT MARKET

The Institute of Chartered Accountants in England & Wales ('The Institute') is pleased to respond to your request for comments on *Choice in the UK Audit Market*.

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

Yours sincerely

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ICAEW REP 44/06

CHOICE IN THE UK AUDIT MARKET

Memorandum of comment submitted in August 2006 by the Institute of Chartered Accountants in England & Wales, in response to the Financial Reporting Council's discussion paper 'Choice in the UK Audit Market' published in May 2006

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INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales (the 'Institute') welcomes the opportunity to comment on the consultation paper *Choice in the UK Audit Market* published by the Financial Reporting Council (FRC).

WHO WE ARE

2. The Institute of Chartered Accountants in England & Wales is the largest professional accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade & Industry (DTI) through the FRC. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR POINTS

4. As you will be aware, the current debate was initiated by a report from the Audit Quality Forum¹ ('the AQF report'), which arose in response to concerns raised about a lack of choice of auditors resulting from the high degree of concentration at the large company end of the audit market. The AQF report, available at www.icaew.co.uk/auditquality, discussed possible barriers to entry and called for research into a number of aspects of the market. We are pleased that the DTI and FRC took up this call, commissioning a research report by Oxera² ('the Oxera report'). We also welcome the action by the FRC in taking the debate forward.
5. We note that although the Oxera report did not set out to examine anti-competitive practices, it noted that there were no suggestions of monopolistic behaviour by the large audit firms, which echoes the findings of the Office of Fair Trading in its 2001 report 'Competition in Professions'. It follows that the current level of concentration in the market is at least partly the result of market demand. It is not yet clear what the extent of any competition and choice problem is for business. To the extent that there is one, we believe therefore that market-based actions will prove to be the most effective route to achieve an impact, given the right information. As such actions tend to involve information dissemination, persuasion and education, they may not have an immediate effect. They do however, tend to be more effective as, once accepted, they work with the market, and avoid the unintended consequences that often follow from regulatory actions.
6. In preparing this response, we called for views from members at large and actively consulted a number of parties with a clear interest in this area. The ideas set out in the rest of this response reflect the opinions passed on to us in the interests of open

¹ *Shareholder Involvement – Competition & Choice*, Audit Quality Forum, July 2005.

² 'Competition & Choice in the UK Audit Market': Oxera, April 2006.

debate: at this stage in the debate we believe it to be more useful to put forward all ideas for debate, rather than to narrow them down to a set position. These comments do not comprise Institute policy proposals: in particular we have concerns about any measures that involve regulatory intervention for the reasons noted above.

RESPONSES 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?

7. As noted above, the debate was initiated in the Audit Quality Forum as a response to specific concerns about choice at the large company end of the market. The AQF report accordingly concentrated on the issues at that level. Nevertheless, it did note:

“...there is also a potential future concern right at the other end of the market, where smaller companies are typically audited by small firms of auditors. Between 31 December 2000 and 31 December 2004, the number of firms registered with the Institute of Chartered Accountants in England and Wales to carry out audit work, fell from 7,061 to 5,475. The working party believes the cause of this to be not only the increases in the statutory audit threshold, but the impact of regulation on the cost and complexity of audit. The trend is therefore likely to continue and the impact will be felt most notably outside large urban areas, where registered auditors are more thinly spread geographically.”

By 31 December 2005 the number of registered audit firms had fallen a further five per cent to 5,193.

8. At a national market level the restriction of choice clearly manifests itself at the large company end of the market, particularly in specialised business such as financial services. Outside of this limited area there is a practical choice between a much wider number of firms. However, there is an issue at the local level, at the small company end of the audit market. Choice is likely to become more of an issue for these businesses as the number of firms carrying out audits declines. While the increase in the audit threshold has undoubtedly contributed to this, we are frequently told that the increased complexity and cost of audit regulation, referred to elsewhere in this response, is a factor. This should be borne in mind when determining any actions, to make sure the benefits cascade throughout the 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?

9. We note that although the Oxera report did not set out to examine anti-competitive practices, it noted that there were no suggestions of monopolistic behaviour by the large audit firms:

“the general perception is that audit quality in the UK has, as yet, largely been maintained at acceptable standards, and some competitive pressure remains for the audit business of those large companies that still have a choice among the Big Four firms.”

This echoes the findings of the Office of Fair Trading in its 2001 report ‘Competition in Professions’. It also echoes a report in 2003 by the US government General Accounting Office, which found that while the level of choice was undoubtedly restricted for large public company audits, the market in the US was working effectively and that there was no widespread appetite amongst stakeholders for regulatory intervention to stimulate more choice. It follows that the current level of concentration in the market is at least partly the result of market forces and that market-based information-dissemination actions are therefore the most likely to have an effective impact, in terms of being proportionate to the issue. Existing regulation should also be reviewed, as considered below. Further regulatory intervention, however, would need first to consider whether there is evidence that any competition and choice problem is on such a scale as to merit such action in the public interest.

10. Auditing is a regulated profession but the extent of that regulation has created a number of the barriers to entry into the audit market: for example the increased complexity of, and cost required to adhere to, standards and the 8th Directive-derived audit firm control rules. While high audit quality is clearly paramount, action in considering whether all such regulations are necessary and appropriate is vital.
11. Before further regulatory intervention is undertaken, the nature and scale of any problem would need to be considered. Is there an issue at all? If there is, is it confined to a small number of very large companies operating in specialised industries? Is any problem a widespread competition issue arising as a result of perception issues? Or is it a problem created by regulation? A number of potential intervention actions are noted below to maintain open debate in the public interest. However, these would need to be considered carefully, as regulatory action usually has a cost (the quantum of which is not always easy to determine), it can often result in unintended consequences and it is important to ensure that any benefit clearly exceeds that cost. A thorough Regulatory Impact Assessment is a vital pre-requisite to any such intervention.

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.

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.

12. These questions address measures that would seek to ease choice issues by opening up the market, and they have been dealt with together.

13. Paragraphs 14 to 20 set out views that have been passed to us as a result of our consultation process. The status of these comments is referred to in paragraph 6.
14. The AQF report suggested that audit committees and boards of large companies tend to consider big four auditors exclusively as a result of perception issues:

“whether as a result of the ‘deep pocket syndrome’, lack of information about shareholders’ views, a perceived need for a large global network, perceived quality differences caused by the next tier audit firms not being present in the FTSE100, familiarity, specialisation or network coverage issues”.

We note that the Oxera report confirms this and notes in particular that audit committees and boards tend to assume investors want big four auditors, rather than asking them. A variety of measures have been suggested based on improving information flows to and from audit committees and boards as regards their choice of auditor. These include:

- a) Directly including investors in the selection process, although practical issues clearly arise as to, for example, which investors would be included.
- b) Public statements by investor groups clarifying their intentions as regards choice of auditor. We note that this has already begun to happen, which is an encouraging indication that the debate itself can result in information-dissemination actions.
- c) Encouraging audit committees and boards to make a statement as to why they are proposing a particular audit firm for election at the AGM. An alternative would be for a statement to be made in the annual report that the arrangements for the continuing appointment (or otherwise) of the existing audit firm have been properly considered.
- d) Generally accepted guidance for audit committees and boards on what to look for in audit appointments. The Institute, for example, produced a guide *Evaluating your Auditors* as part of a series for audit committees in 2003. This, suitably updated, could be the basis for such guidance. The guidance could, for example, highlight that although one audit firm accepts responsibility for the group audit opinion, it is not always necessary to use the same audit firm in every location provided proper quality control arrangements are in place, in order to complete the group audit work.
- e) Encouraging audit firms to publicise what industries/specialisations they are interested in taking on the audits of, to inform audit committees and boards better.
- f) Encouraging tenders to include at least one non-big four firm, though this would need to follow a change in attitude. Without that, such a measure could end up having little effect beyond imposing wasted time and effort on the non-big four firms.

- g) To overcome equating brand recognition with quality, publication of details of audit quality monitoring reports by the Audit Inspection Unit. We are aware that the Professional Oversight Board is currently consulting on this and the Institute will respond separately to that consultation.
15. It is not just audit committees and boards that would need to be targeted with the information-dissemination measures noted in paragraph 14 above. A number of examples have been mentioned to us where suggestions are made to companies by other advisors, for example investment banks, that a big four auditor would be preferred. This is particularly relevant in the case of growing companies. Where non-big four audit firms do retain large audits, it is usually because they were appointed auditors while the client was smaller, but have retained the audit as the client grew. This is more likely to be a source of growth in numbers of FTSE 100 audits for non-big four audit firms over time, than several very large companies suddenly changing to smaller audit firms. We note, by way of example, that the concentration of audits in the hands of the big four is much greater for companies listed on the full market than it is for those on AIM, even though companies with full listings outside of the top tier have similar characteristics to those listed on AIM. We wonder whether 'expectations' of what a company on the full market should do, play a part in this and believe there may be merit in exploring this further:
- a) If some of the measures outlined in paragraph 14 are targeted more widely than audit committees and boards, they should achieve a change in attitude over time and there would be expected to be an increase in the number of non-big four firms retaining audits into the higher levels.
 - b) It has been suggested that fixed-term contracts, as operated in France, might give smaller firms a chance to prove their abilities after their clients had floated. However, this could be seen as a sledgehammer to crack a nut and would need to be considered very carefully. It would be a major departure from existing UK practice in terms of shareholder rights and would be difficult to implement without having unintended consequences: changes of auditors are usually made for very good reasons. It could also lead to a presumption of firm rotation at the end of the contract: research has shown regular audit firm rotation does not enhance audit quality.
16. As part of the separate debate on auditor liability reform, during the passage of the Company Law Reform Bill, it was observed by some commentators that unlimited liability is a deterrent (albeit not necessarily the main one) to non-big four firms entering the larger company end of the audit market. We address liability reform itself under the response to questions 6 and 7 below (though it is also relevant here), but a suggestion emerging from this debate is that audit fees do not adequately price in the risk factor. In an unlimited liability environment it is impossible for any audit firm to price in the risk factor properly. In practice this becomes a bigger impediment for smaller audit firms who are faced with the step change in their risk profile if they move beyond their traditional client base.
17. A number of suggestions have been put forward that some of the larger non-big four audit firms should merge to create a big five. This presumes that size is a

critical factor, which may not be the case in most appointments, although a small number of large businesses will necessarily require significant audit resource. Even so, such a merger would be unlikely to be successful unless initiated by the firms themselves, with a view to creating a big four rival. We note that the structures and cultures of these firms do vary significantly and that in the UK it would require numbers 5, 6, 7 and 8 to merge to result in a firm the size of any one of the big four. Accordingly this is unlikely to be a short-term solution but if the market itself were to signal the need for a merger it might create a platform for the new firm to grow over a period of time to become part of a big five. This would not fundamentally change the current audit market structure but might lead to some choice problems being eased.

18. The Oxera report notes that changing auditors is not a frequent occurrence. One reason is that because of the unique nature of each business and thus each audit, changing auditors is a time-consuming business for the client management as well as the auditor. A suggestion has been made that on changing auditors the outgoing firm should, *ceteris paribus*, be required to hand over copies of the audit papers to the incoming firm, thus easing the information flow. As the audit papers belong to the auditor rather than the client this would require regulatory action and as with other such proposals there are a number of issues (for example, confidentiality of proprietary methodologies and liability concerns) that would need to be addressed.
19. Joint audits are required in France for listed entities and often at least one of the auditors is a non-big four firm. Joint audits are already permissible in the UK but the market seems to have rejected the notion: such arrangements are noticeably rare, as they are seen as imposing extra cost, and can complicate liability and quality issues. Regulatory intervention to impose joint audits would be a drastic approach and it would need to be clear that there is a problem to which this is an appropriate and proportionate solution, with consequent benefits exceeding the extra cost.
20. There are a number of potential actions related to the actions of audit regulation itself in creating barriers to entry:
 - a) The increased complexity of auditing and independence standards is imposing extra cost on auditors both in terms of what they must do (e.g. prescribed documentation) and what they must not do (independence). This has a number of consequences:
 - i. at the smaller end of the market the increased cost and complexity is undoubtedly an influencing factor on the decline in numbers;
 - ii. as larger firms can spread the cost of technical resource more widely, regulatory complexity disproportionately impacts upon smaller and medium-sized audit firms; and
 - iii. at the larger end of the market, the non-audit service prohibitions are a key factor in the reduction in choice upon specialist businesses such as financial services.

Regulation needs to be proportionate and as flexible as possible (i.e. principles-based) within the overall requirement to maintain quality. Standard setting also needs to reflect the needs of stakeholders across the whole

spectrum of the market. Competition effects should be considered as part of Regulatory Impact Assessment, which necessitates consideration of where it fits with other regulatory objectives in terms of priorities.

- b) Liberalisation of the control rules for audit firms. These are derived from the European Union 8th Directive and would thus require co-ordinated action but in principle it should be possible to have measures to protect audits from undue influence without requiring majority ownership by persons qualified to carry out audits. We note that the European Commission intends to carry out research into ownership of audit firms. Such research may indicate whether there is an appetite outside of the audit industry to enter it or within the industry to expand audit capacity if capital were more easily obtainable.
- c) It is important from a competition perspective that auditing standards do not impose different requirements for group audits being undertaken by one network, than those being undertaken by several firms. We note that such a proposal has been removed from a re-exposure draft of the IAASB standard on group audits. However, the issue may resurface in, for example, consideration of the work of experts.
- d) At the smaller end of the market, there is a case for a thorough review of the expectations and regulatory requirements for the audit of small businesses at a certain level above the current audit threshold. To be beneficial, this would require at least some action at EU level as minimum audit thresholds are specified in European law.

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.***

21. The current position has largely been brought about by the market itself through real and/or perceived need and no one action of itself is likely to change choice in the audit market significantly. The measures put forward for debate are not mutually exclusive and could be actioned in parallel. However, what must be considered is the nature of each measure and thus the costs and the consequences.
- a) As noted above, and in the discussion paper, market based information-dissemination actions are generally most effective, do not require significant cost and do not have the unintended consequences that so often follow from regulatory intervention. These could therefore be fast-tracked, with stakeholder buy-in.
 - b) The need to ensure that regulation is fit for purpose, proportionate and representative of the needs of all stakeholders is something that we would encourage regulators to consider transparently on a continual basis.

- c) The measures that involve positive regulatory intervention require a careful assessment of the extent of the issue (as discussed in paragraph 11). They would also need a Regulatory Impact Assessment and detailed consideration of any unintended consequences. They would, if appropriate for consideration at all, need to be allocated a much longer time frame for research consultation and consideration.

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

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.

- 22. These questions address measures that would seek to ensure that choice issues are not exacerbated, by seeking to minimise the likelihood of further concentration at the top end, and they have been dealt with together.
- 23. Paragraphs 24 and 25 set out ideas that have been passed to us as a result of our consultation process. The status of these comments is referred to in paragraph 6.
- 24. A fundamental requirement is to ensure that audit is not an unattractive business to be in for firms and that they are not deterred as a result of unreasonable claims or over-regulation. Some of the regulatory issues noted in paragraph 20 are also relevant here, as is the importance that audit fee pricing be efficient but reflect the risk factor, referred to in paragraph 16.
- 25. One of the scenarios in which one or more of the big four leaves the audit market is that a claim succeeds that is in excess of the ability of the audit firm, even with insurance, to pay. There are a number of aspects that can be considered in terms of trying to reduce this:
 - a) The Institute has consistently advocated reform to permit audit liability to be set on a proportional basis. Under this scenario auditors remain responsible for the consequences of their own actions and this, combined with reputation damage, could mean that even a large firm could fail. Nevertheless, proportional liability limitation ensures that auditors are not required to make good on claims relating to the consequences of others' deeds, as they are at present. The Company Law Reform Bill includes provisions permitting limitation by contract and it is to be hoped that these will be enacted, implemented equitably and prove effective. The complexity of international audits and audit firm networks means that to be fully effective, liability limitation needs to be considered at an international level too: a) there is a concern among some networks that holding themselves out as one network could attract claims by association; b) if unlimited liability causes a national part of a network to be brought down, the publicity would have an adverse effect on the rest of the network; and c) in principle, one source of competition might be for audit firms elsewhere in the EC to enter the domestic market directly. While regulation and brand recognition do not make this easy, it does mean that a firm in one part of the EU could have a direct interest in the

liability regime elsewhere. We note that the European Commission is currently considering the case for liability reform at a European level, which is a start.

- b) There needs to be a clear consensus between stakeholders as to what an audit can and should reasonably entail. As discussed in the publication *Audit Quality: Fundamentals*, available at www.icaew.co.uk/auditquality, this is the principal reason the Audit Quality Forum was convened by the Institute. Open debate should be encouraged in this area at a national and international level.