



Choice in the UK Audit Market
Interim Report of the Market Participants Group
April 2007

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Executive Summary

The Market Participants Group was established in October 2006 to provide advice to the Financial Reporting Council on possible actions that market participants could take to mitigate the risks arising from the characteristics of the market for audit services to public interest entities* in the United Kingdom. The Group is comprised of individuals from companies, investors and audit firms.

The Group noted that due to the level of auditor concentration there is a high degree of concern amongst market participants over the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. This risk could be mitigated through increased choice of auditors. However a number of current market characteristics, when taken together, reduce the propensity of non-Big Four firms to offer to audit public interest entities and the propensity for public interest entities to select non-Big Four firms as auditors.

The Group evaluated a wide range of possible actions to increase choice of auditors. It decided that possible actions should, when combined with others, contribute to increased choice whilst at least maintaining audit quality, at a cost which is proportionate to the likely benefits and at a cost which is lower than any alternatives offering equivalent benefits.

This interim report sets out provisional recommendations for actions which the Group currently believes could, when taken together, enhance the efficiency of the market and in so doing mitigate the risks associated with a firm leaving the market. The main objectives of the 15 provisional recommendations are to:

- Make investment in the supply of audit services more feasible
- Reduce the perceived risks to directors of selecting a non-Big Four firm
- Improve the accountability of boards for their auditor selection decisions
- Improve choice from within the Big Four
- Reduce the risk of firms leaving the market without good reason
- Reduce uncertainty and disruption costs in the event of a firm leaving the market.

The provisional recommendations set out actions that could be taken by market participants working collectively, some of which require support from regulators, to allow the market to work more efficiently. The Group believes that its package of provisional recommendations could result in individual market participants having greater incentive to act in ways that could, in the long term, lead to increased choice of auditors.

The Group considers that agreement over market-based measures in the UK would make a useful contribution to the wider international debate on audit market concentration. A wide degree of market support would be needed to ensure the success of market-based actions and the Group will therefore consider responses to the consultation questions shown on page 11 before finalising its recommendations.

* Public interest entities means entities that are of significant public relevance because of the nature of their business, their size or the number of their employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings.

Introduction

The objectives of the 'Choice in the UK Audit Market' project are to identify, assess and promote actions to enhance the efficiency of the market for the audit of public interest entities in the UK and mitigate the risks arising from the characteristics of the market. The intended outcomes from this project include:

- Increased choice of auditors
- Reduced risk of an audit firm leaving the market without good reason
- Reduced uncertainty and disruption costs in the event of an audit firm leaving the market.

In undertaking this project, the FRC recognised the importance of the quality of audit work and committed to avoiding actions that would damage the quality of audit services.

Details of the project are available at <http://www.frc.org.uk/about/auditchoice.cfm>.

In the first stage of the project the FRC:

- Jointly with the Department of Trade and Industry commissioned a study, "Competition and Choice in the UK audit market", which was published in April 2006
- Published a Discussion Paper for consultation in May 2006
- Facilitated a public debate by hosting two stakeholder meetings (in April and September 2006) and publishing responses to the Discussion Paper.

During the first stage of the project, it emerged that the nature of the risks associated with the current characteristics of the market for the audit of major public interest entities are such that actions may be required by each of:

- Market participants acting individually
- Market participants acting collectively
- Regulatory authorities
- Government and legislators.

Those who participated in the first stage of the project had a strong preference for market-led solutions. The Market Participants Group was established in October 2006 to provide advice to the FRC and, in particular, to identify and assess possible actions which market participants could take to mitigate the risks arising from the characteristics of the market.

The Market Participants Group

The Market Participants Group comprises individuals from stakeholder groups in the market for the supply of, and demand for, audit services to public interest entities in the UK. The three principal stakeholder groups are:

- The entities being audited
- The firms providing audit services
- Shareholders and other users of audit services.

A list of members of the Group is shown in the Appendix. In line with its terms of reference, the Group has:

- **Defined the risks arising from the characteristics of the market:** The Group noted that due to the level of auditor concentration there is a high degree of concern amongst market participants over the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. In addition some market participants consider that there would be benefits from increasing choice from the current level.
- **Defined the criteria by which possible actions to mitigate risks should be assessed:** The Group decided that possible actions should, when combined with others, contribute to achieving the intended outcomes whilst at least maintaining audit quality, at a cost which is proportionate to the likely benefits and at a cost which is lower than any alternatives offering equivalent benefits.
- **Carried out a high-level assessment of a 'long list' of possible actions:** The Group evaluated a wide range of possible actions that could help to manage the risk. It considered current market characteristics identified in the Oxera study, the characteristics that might be found if the market was to operate more efficiently, and actions to help achieve such enhanced efficiency that were suggested in the first stage of the project.
- **Carried out further assessment of a selection of possible actions to mitigate risks:** The Group recognised that the intended outcomes could only be achieved through the actions of individual market participants. However, changes to the way the market operates would be needed so that individual market participants had greater incentive to act in ways that would achieve these outcomes. It would not be feasible to achieve the outcomes through one, or a few, actions to change the way the market operates. The Group therefore developed a package of actions, some of which require support from regulators, which it considered would best meet the agreed criteria.
- **Reported on the outcome of the assessments:** The Group has set out in this interim report the package of possible actions which it believes could result in individual market participants having greater incentive to act in ways that could lead to increased choice of auditors, reduced risk of an audit firm leaving the market without good reason and reduced uncertainty and disruption costs in the event of an audit firm leaving the market. The Group believes that its package of provisional recommendations is worthy of consideration by the market through public consultation. It will consider responses to the consultation before finalising its recommendations.

The Group considers that the package of provisional recommendations could have a positive impact on the degree of concentration in the supply of audit services to all but the very largest public interest entities over the medium term. In the longer-term this may provide a platform for non-Big Four firms who successfully respond to the opportunities created to expand into the audit market for the very largest public interest entities. The provisional recommendations could also reduce the risk of a firm leaving the market without good reason and contribute to mitigating the uncertainty and disruption costs in the event of a firm leaving the market.

The market for audits of public interest entities

- As shown in Table 1, most large listed companies purchase their audit services from the Big Four audit firms – Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers. This high level of supply concentration follows mergers between audit firms over many years and the dissolution of Arthur Andersen. The Big Four's overall share of the FTSE 350 has been fairly constant for several years. Between 10 and 20 companies within the FTSE 350 change auditor each year, usually within the Big Four (Table 2).
- Audit is a public interest function and the operation of the market is subject to extensive regulatory and legislative requirements.
- Several features of the market for audit services to public interest entities contribute to the tendency of public interest entities to use the largest audit firms with the strongest existing reputations:
 - In selecting and appraising auditors, audit committees look at the 'added value' that firms bring to the company – including accountancy advice and the limitation of the personal and reputational damage of significant accounting misstatements.
 - It is more difficult to assess objectively the quality of an audit firm without experience of working with that firm.
 - Non-executive directors and others selecting or influencing the selection of auditors are more likely to have experience of working with the (now) Big Four rather than non-Big Four firms.
 - The process of switching auditors is costly for both the companies and auditors.
- Reflecting the current market structure, most major public interest entities are perceived to have a choice of a maximum of four audit firms. This choice can be further limited by auditor independence regulations if companies choose to use Big Four firms for certain non-audit work or if the audit firms have certain types of financial, business, employment or personal relationships with the company. Choice appears to be particularly limited for some financial services companies.

Table 1 Number of companies audited by firm, February 2007

Auditor	FTSE 100		FTSE 250		FTSE Small Cap		AIM
	(2005)	(2005)	(2005)	(2005)			
PwC	40	(43)	75	(82)	128		112
KPMG	23	(22)	57	(64)	110		167
Deloitte	19	(17)	64	(54)	97		116
Ernst & Young	18	(17)	46	(42)	113		98
BDO Stoy Hayward	0	(1)	5	(4)	19		141
Grant Thornton	0		1	(1)	12		167
RSM Robson Rhodes	0		1	(1)	29		43
Begbies Chettle Agar	0		1	(1)	1		0
Baker Tilly	0		0		13		111
PKF	0		0		9		49

Source: Hemscott February 2007 (2005 comparisons from Oxera, page 60).

Note: For all UK-domiciled non-FTSE 350 companies on the main market, the proportion using Big Four is similar to the shown above for FTSE Small Cap i.e. around 85% use Big Four.

Table 2 Percentage of listed companies in 2004 that switched auditors 1996-2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004	Avg.
Listed companies (%)	3.0	4.4	6.2	4.5	3.5	4.9	5.5	3.4	2.8	4.2
FTSE 100 (%)	2.0	0.0	1.9	1.6	3.1	2.9	2.6	3.8	1.2	2.1
FTSE 250 (%)	0.7	3.2	4.9	2.4	0.6	3.9	4.9	2.7	1.6	2.8
FTSE Small Cap (%)	3.2	4.1	7.4	5.2	4.6	5.9	4.5	3.2	3.1	4.6

Source: Oxera, page 44, based on the Oxera panel dataset that included companies that appeared in the relevant main market index in 2004 and for which data was available.

Objective A – Increased choice of auditor for public interest entities

- The Group considers that increased choice for public interest entities requires both an increase in the propensity of non-Big Four firms to offer to audit public interest entities (the “**supply side**”) and an increase in the propensity for public interest entities to select non-Big Four firms as auditors (the “**demand side**”). The effectiveness of actions on the supply side would be enhanced by those on the demand side and vice versa.
- On the **supply side** the Group believes that the principal responsibility for the decision to make this investment and to secure appropriate sources of finance rests with individual firms. The most important development would be additional investment by the existing non-Big Four firms or new firms in perceived and actual capabilities to audit public interest entities. The following provisional recommendations are designed to make such investment more feasible:
 1. The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality. (A.1.1, pages 16-17)
 2. Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis. (A.1.2, pages 18-19)
 3. In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality. (A.1.3, pages 20-21)
 4. Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms. (A.1.4, pages 22-23)
- On the **demand side** the Group believes that the primary responsibility for the selection of auditors of public interest entities should remain with their boards. However to help achieve the intended outcomes for the project, the risks to directors of selecting a non-Big Four firm would need to be reduced and boards would need to be more accountable to shareholders for their auditor selection decisions. The following three provisional recommendations are designed mainly to reduce the risks associated with choosing to select a non-Big Four firm:
 5. The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency of the capabilities of individual audit firms. (A.2.1, pages 26-27)
 6. The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor. (A.2.2, pages 28-29)
 7. The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network. (A.2.3, pages 30-31)

Objective A – Increased choice of auditor for public interest entities (ii)

- The next three provisional recommendations are directed at improving the accountability of boards for their auditor selection decisions.
 - 8 . The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision. (A.2.4, pages 32-33)
 - 9. When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms. (A.2.5, pages 34-35)
 - 10. Investor groups, corporate representatives and the FRC should develop good practices for shareholder engagement on auditor appointment and re-appointments and should consider the option of having a shareholder vote on audit committee reports. (A.2.6, pages 36-37)
- The Group is aware that its provisional recommendations on the demand side could result in an increased rate of audit tendering, particularly for companies that have not actively considered alternatives to their incumbent auditor for many years. However the Group considers that companies would only need to incur the cost of putting the audit out to tender when they judge that a change of auditor could be beneficial.
- Because it could take many years before additional investment could contribute to a meaningful increase in choice for the very largest public interest entities, the choice available to many of those entities is restricted to the Big Four firms. We have, therefore, also considered how to increase the potential for switching between the Big Four firms. We believe that provisional recommendations 6 and 7 could contribute to increased choice for the very largest public interest entities. In addition we have identified the following:
 - 11. Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence. (A.3.1, pages 40-41)
 - 12. The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors. (A.3.2, pages 42-43)

Objective B – Reduced risk of a firm leaving the market without good reason

- Because it could take many years for the Provisional Recommendations under Objective A to lead to increased choice of auditors for major public interest entities, the market is likely to be faced for some time with a significant risk of uncertainty and disruption in the event of a major audit firm leaving the market. Although there could be circumstances in which it might be entirely appropriate that a firm should leave the market, it is also possible that firms might leave the market without good reason. The Group identified three main ways in which the risk that a firm might leave the market without good reason could be reduced:
 - Increasing the likelihood that the market responds appropriately to an issue which might potentially cause a firm to leave the market.
 - Reducing the value of meritorious claims against audit firms.
 - Increasing the resources available to firms to deal with claims against them.
- In increasing the likelihood that the market responds appropriately to an issue which might potentially cause a firm to leave the market, the primary responsibility must remain with the firm itself. Companies also have a role in planning for how they monitor and react to news about their audit firm. The Group considered that market participants needed greater visibility and clarity of the possible level of regulatory penalties on an audit network of rule breaches:
 - 13. Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness. (B.1, pages 47-48)
- In reducing the value of meritorious claims against audit firms, it was noted that the firms themselves have strong incentives to govern their affairs in such a way as to minimise risks. However the Group considered that users of audit services should be given information about the firms' corporate governance arrangements and that these should comply with standards equivalent to those of public companies:
 - 14. Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions. (B.2, pages 48-49)
- In increasing the resources available to firms to deal with claims against them the Group noted that changes to auditor liability arrangements, as envisaged in section A.1.3, might in the long term improve the availability of insurance, although this is not certain particularly at the top end of the market.

Objective C – Reduced uncertainty and disruption costs in the event of a firm leaving the market

- Because, notwithstanding the Provisional Recommendations under Objectives A and B, it would be both impossible and undesirable to eliminate the possibility of a firm leaving the market, the Group considered how it might be possible to reduce the uncertainty and disruption costs which would result. Although some of the responsibility for planning for the continuity of audits, or alternatives to audits, rests with regulators and government, there are actions which market participants could take before the possible loss of a firm and actions which would only be required in the event of a firm leaving the market.
- In particular the Group considered that it was appropriate for all public interest entities, particularly those who perceive their choice of auditor to be limited to the Big Four, to identify and consider the need to manage the risk of the loss of their auditor:

15. Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning. (C.1, pages 52-53)

Consultation questions

The Market Participants Group invites responses to the following questions:

- **Do you support the three criteria used for assessing the merits of the provisional recommendations, as shown below? If not, please proposed preferred criteria.**

Effectiveness:	Whether actions would, when combined with others, contribute to achieving the intended outcomes:
Quality:	<ul style="list-style-type: none">○ Whilst at least maintaining audit quality
Cost:	<ul style="list-style-type: none">○ At a cost which is proportionate to the likely benefits and which is lower than alternatives offering equivalent benefits.

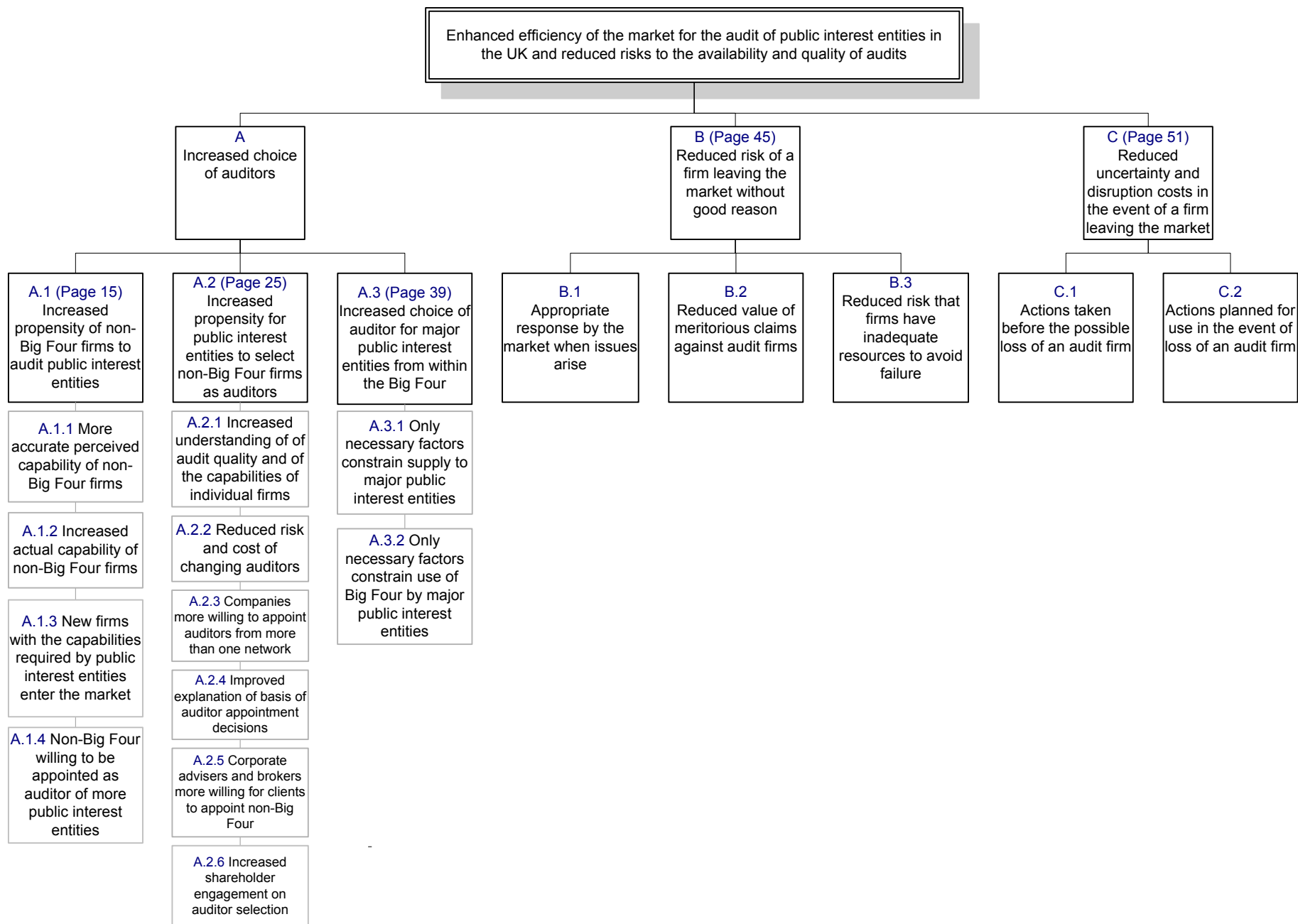
- **For each provisional recommendation:**
 - **Do you support the stated objective of the recommendation?**
 - **Do you agree with the assessment of the recommendation or if not, why not?**
 - **What alternative or additional recommendations could achieve the desired objective in a way that meets the assessment criteria?**
- **Are there other characteristics of a more efficient market which should be considered for inclusion in the report? What additional recommendations could contribute to the achievement of these other characteristics?**

Written responses to the consultation questions are invited by Friday 6 July 2007. Responses should be sent to: Julian Rose, Secretary, Market Participants Group, Financial Reporting Council, 5th Floor, 71-91 Aldwych, London, WC2B 4HN. Email: j.rose@frc.org.uk. Telephone 020 7492 2342. Responses will be acknowledged and will be published on the FRC's website in early July. If you do not want all or part of your response, or your name, made public please state this clearly in your response and, if possible, please also provide a non-confidential version for publication.

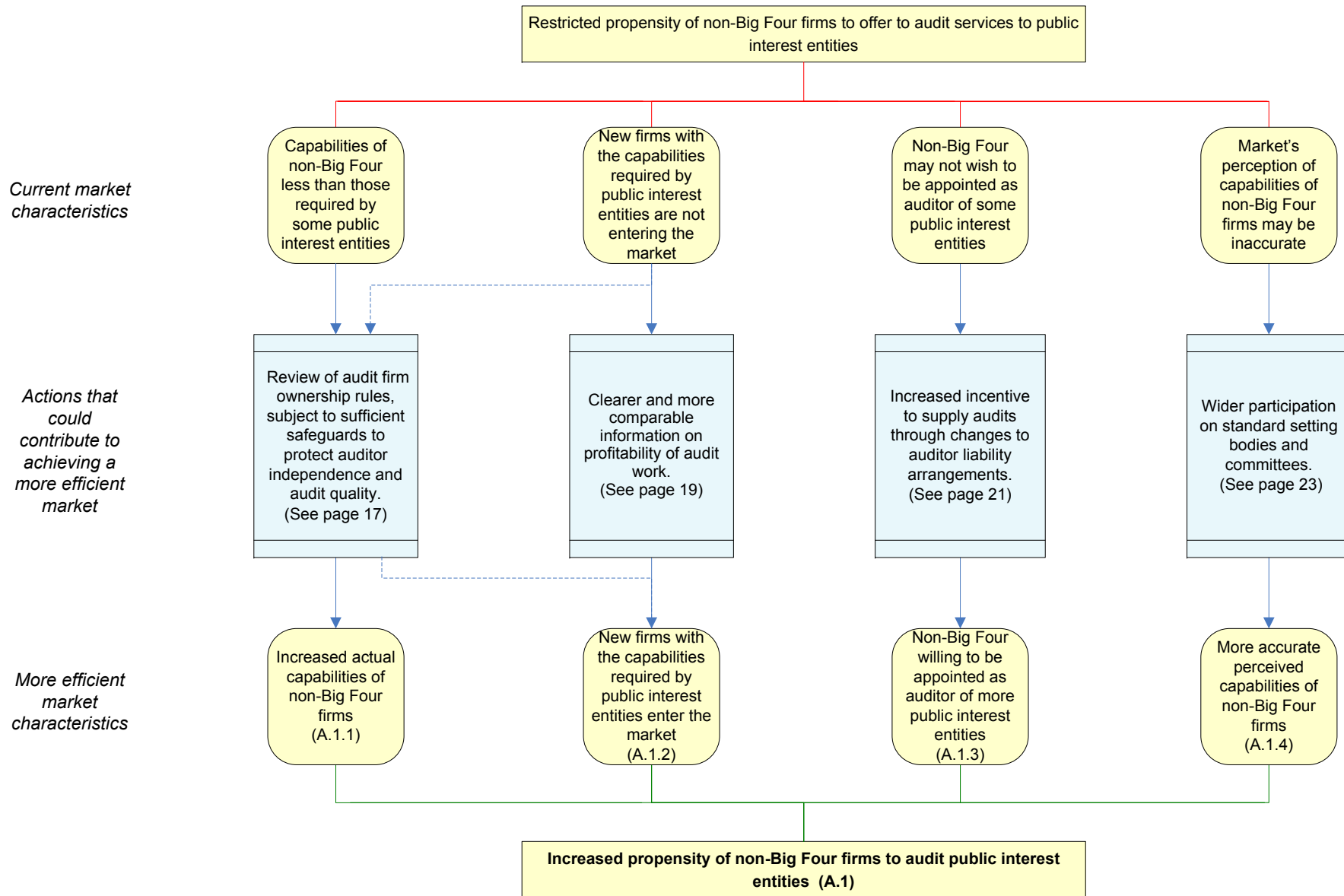
To assist those responding to the consultation, a stakeholder meeting will be hosted by the FRC on 10 May 2007 at 4pm in London. This meeting will discuss the MPG's interim report and initial views on the consultation questions shown above. Details and registration arrangements are available at www.frc.org.uk/about/auditchoice.cfm.

Analysis supporting provisional recommendations

Summary of objectives of provisional recommendations



A.1 Increased propensity of non-Big Four firms to audit public interest entities - Summary



A.1.1 Increased actual capabilities of non-Big Four firms

Current market characteristics

- The Oxera study concluded that there are significant economic barriers to immediate new entry into the market for audit of major public interest entities. While operating in the FTSE 100 and FTSE 250 segments can be in principle be profitable, Oxera found, the initial expansion would require substantial investment.
- The ability of firms to raise external capital to finance the investment is restricted by the Companies Act (and by European law) which requires audit firms to be controlled by qualified auditors. Given the multidisciplinary nature of audit firms, a sizeable percentage of partners and owners are not auditors, limiting firms' ability to raise even small amounts of equity finance without restructuring.
- For existing firms, the scale and risk of the investment required might not be attractive to some of the partners of existing non-Big Four firms as a result of limits, due to retirement, on the period that they can personally receive a return on the investment.

Effects of current market characteristics

- The ability of existing or new audit firms to raise substantial external equity finance for investment is limited.
- Some existing non-Big Four firms may be limited in the degree by which they can rely on partners' funds to make a step change in the level of investment in capacity to deliver audit services to the FTSE 350 segment.

Characteristics of a more efficient market

- Should operating in the FTSE 350 segment have the potential to be profitable for a non-Big Four firm, that firm should be able to raise the necessary investment.
- Controls over the ownership of audit firms do not exceed the level necessary to protect audit quality.

Selected views from responses to the FRC's 2006 discussion paper

[Control rules for audit firms] 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. *ICAEW*

We do not believe that existing laws and regulations constrain the entry of new participants to the market, but the very nature of the market itself makes it difficult for new participants to enter. *National Audit Office*

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 Four firms. Equally it might exacerbate the existing concern over the current business models and revenue generation policy of the firms, at the expense of audit quality considerations. *Morley Fund Management*

It would be sensible to review whether there is a case for raising the scope for outside capital to be applied to the audit industry. European regulations currently prevent more than 40 per cent of any firm being owned by non-auditors. This issue was not raised in the discussion paper, but we acknowledge it is a complex one. We believe it should be given careful and balanced consideration so that the market can be satisfied that access to capital is not a constraint to competition. *Association of British Insurers*

A.1.1 Increased actual capabilities of non-Big Four firms (ii)

Provisional recommendation 1

- The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules subject to there being sufficient safeguards to protect auditor independence and audit quality.

Commentary on provisional recommendation

- The primary responsibility for increasing their capabilities rests with the non-Big Four firms. Although the existing non-Big Four firms have not expressed any concern in public over their ability to raise external finance due to the audit firm ownership rules, it is possible that the rules could constrain step changes in future investment by these or by new firms.
- The question as to whether it is possible to widen the sources of capital available to audit firms whilst preserving auditor independence and audit quality is a complex one which requires detailed consideration. The European Commission has commissioned a study on ownership rules applying to audit firms and the consequences these rules have on audit market concentration. The study will report later this year. Changes to the ownership rules in the UK would require change to European law.
- There are many categories of business which are subject to regulation on grounds of user protection where the regulatory requirements are primarily addressed to the way in which the business is conducted rather than to the owners of the business. For example, those flying airplanes are required to be qualified pilots but the owners of airlines are not. In the legal profession, the Clementi Review concluded that non-lawyers should be permitted to be Managers of Legal Disciplinary Practices subject to the principle that lawyers should be in a majority by number in the management group. The Group believes that, in principle, it should be possible for regulatory requirements that relate to audit quality and independence to be applied to the operations of firms rather than to the owners.

Evaluation of provisional recommendation

- *Effectiveness:* Changes to ownership rules could help to remove a potential barrier to step changes in investment by existing firms or new entry by a firm with the capabilities required by public interest entities. It has been suggested that changes to ownership rules might lead to increased investment by Big Four firms. This might happen but it seems unlikely that it would have the effect of making new entry to the market even more difficult than it is today.
- *Quality:* The requirement for audit firms to be controlled by registered auditors was introduced many decades ago to guard against 'undue pressure' that may damage the integrity of audit work. Since then significant regulatory requirements which directly support audit independence and quality have been introduced. These requirements would apply to firms that were majority owned by non-auditors. Consideration would need to be given as to whether any additional requirements to safeguard independence and quality are required where firms are majority owned by non-auditors.
- *Cost:* No significant effect.

A.1.2 New firms with the capabilities required by public interest entities enter the market

Current market characteristics

- As noted in A.1.1, the Oxera study concluded that, unless market conditions and perceptions change, the investment required for substantial entry into the FTSE 100 and FTSE 250 segments was unlikely to be economic.
- In order to assess the business case for investment, potential entrants could make use of the accounts of existing firms amongst other sources of information. Large audit firms report in accordance with IFRS which requires segmental reporting based on how an entity manages its business. Most publish financial results split by lines of service that typically include audit, tax and advisory services. Some firms allocate all revenue and cost to such service lines whereas others show substantial amounts as 'unallocated'.
- The audit segment will, depending on the firm concerned, include a range of associated sources of revenue such as advice on accounting matters and non-audit assurance services. Fees for audit services represented between 54% and 88% of turnover reported under the audit service line in the 2005 financial statements for the five of the six largest firms by turnover that published segmental analysis.

Effects of current market characteristics

- The financial results for audit services provided by the firms may be difficult to interpret. They include a range of different types of assurance services and may include or exclude indirect costs.
- Potential new entrants and others may find it difficult to judge whether the supply of audit services is attractive and hence sustainable.

Characteristics of a more efficient market

- Information on the firms' financial results for audit services is transparent and comparable, helping potential new entrants and others to assess the viability of the supply of these services.

Selected views from responses to the FRC's 2006 discussion paper

.. Particular focus [by competition authorities at both EU and national level] should be given to the cross subsidisation of audit by non-audit services. There is a risk large firms who can afford such subsidisation will use this device to create a barrier to entry by smaller firms. While companies and shareholders are, rightly, concerned about being overcharged for poor quality audit services, it is simple common sense that a fair price for audit is a prerequisite for the maintenance of both choice and quality. *ABI*

For progress to be made, a helpful input would be more detailed information than is currently available from the audit firms and networks, including the Big Four firms, on their own governance and financials at the national and international level. This could include information about insurance costs and contingent liabilities, as well as information about the firms' processes to detect and to punish malpractice. In effect, the nature of incentives and constraints applying to audit partners and firms in most countries is currently shrouded in opaqueness. Absent regulatory requirements (which are already stronger in the UK than in most other countries), the public information provided by audit firms and networks is generally kept at a level which makes it difficult to make an informed judgement, especially regarding the effects of the market's structure. *Nicolas Véron, Bruegel*

The "Big Four" are immensely large firms in their own right, carrying out statutory duties and, therefore, have significant responsibilities to the business community. This responsibility is not however reflected in their governance structures or in the transparency of their reporting. In particular their accounts are not transparent about how the audit practice is conducted and the returns they make from it. *FTSE 100 chairman*

A.1.2 New firms with the capabilities required by public interest entities enter the market (ii)

Provisional recommendation 2

- Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.

Commentary on provisional recommendation

- The objective of this recommendation is to provide the market with clearer and more comparable information on the profitability of audit work. This could assist potential new entrants and others to judge the viability of the supply of statutory audits and directly related services. It could also help market participants to consider how efficiently the market for the public interest function is operating.
- Those responding to the consultation might wish to comment on whether it would be useful to see information relating only to statutory audits and directly related services or relating to the wider audit segment of the firm. It should be straightforward for the firms to determine revenue figures for only statutory audits and directly related services; indeed this information is already published by companies in annual reports.
- The determination of costs attributable only to statutory audits and directly related services and, therefore, the calculation of profitability, is less straightforward. The allocation of costs would, for example, need to take account of differences in the management structures of the firms if the data is to be comparable.

Evaluation of provisional recommendation

- *Effectiveness:* The changes to audit firm ownership rules (see A.1.1) could help lead to new firms entering the market. However new entry might be encouraged by improved information on the attractiveness of the market.
- *Quality:* Limited direct effect.
- *Cost:* Firms would incur extra reporting costs. The firms are already required to separate their billing for statutory audit work from other work as companies are required to report the figures separately in their annual reports. The determination of costs attributable to statutory audit work could require new cost measurement systems depending on the basis on which the costs are to be assigned.

A.1.3 Non-Big Four willing to be appointed as auditor of more public interest entities

Current market characteristics

- Currently liability of the auditor and the audited company towards others (shareholders, creditors) is joint and several. The statutory auditors and the audit firms may bear a portion of charges resulting from the misconduct of the audited company, in particular if that company goes bankrupt.
- The firms have, for many years, been unable to obtain comprehensive insurance for their liability risks. They have, in part, self-insured through the creation of captive insurance arrangements.

Effects of current market characteristics

- Under the current arrangements, some non-Big Four firms may have limited incentive or motivation to audit major public interest entities. Average profit per partner in the largest non-Big Four firms is approximately £350,000 compared to around double that at Big Four firms. Partners in the non-Big Four firm would need to consider whether the prospect of closing this gap could justify what might be seen as a material increase in risk under current liability arrangements. Such a material increase in risk might come directly from taking on a significant client or indirectly from joining or strengthening an international audit firm network.
- The current liability arrangements could discourage new entry to the market and could be a significant reason why a firm might leave the market.

Characteristics of a more efficient market

- Liability arrangements provide a strong incentive to achieve high quality whilst, to the extent appropriate, not discouraging firms from participating in the audit of public interest entities.

Selected views from responses to the FRC's 2006 discussion paper

We obviously welcome the provisions of the Companies Bill in the UK, although it remains to be seen how the “fair and reasonable” test will be applied by the Courts....However, liability reform in the UK will not be enough. A disastrous claim in another jurisdiction, most obviously the US, has the potential to undermine an entire international network. That is why it is vital for suitable liability reform to be implemented, in particular in the US and EU. *Ernst & Young*

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 a real threat...Further limitation of liability provides no incentive to quality and may indeed encourage auditors to cut corners and take risks. *Morley Fund Management*

...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 [controls] 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. *KPMG*

Addressing the risk/reward ratio for firms is essential if more firms are to be induced to participate in the audit of major companies. Within firms of accountants, audit services generally carry higher risk and lower reward than other services offered. The current debate on the liability of auditors and on penalties for firms which make innocent mistakes is key to this. Unless risk/ reward ratios are improved, the likelihood of a Big Four firm collapsing is high and the likelihood of others entering that market is low. *PKF*

A.1.3 Non-Big Four willing to be appointed as auditor of more public interest entities (ii)

Provisional recommendation 3

- In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.

Commentary on provisional recommendation

- The Companies Act of November 2006 permits contractual limitations between a company (subject to shareholders approval) and its auditor. These new arrangements, which are expected to come into force in April 2008, represent the UK's response to concerns over the current liability arrangements, taking into account the possible impact of liability risks on the willingness of firms to be appointed as auditor of public interest entities. The FRC has agreed to appoint a working group to provide a suggested standard form for auditor liability limitation agreements and a suggested process for the effective implementation of such an agreement.
- The policy response to such concerns elsewhere is the subject of ongoing debate. The European Commission published last year an independent study on the economic impact of current EU rules on auditors' liability regimes and on insurance conditions in Member States. The Commission is consulting over options for changing auditor liability arrangements. Options being consulted over are a fixed monetary cap, a cap based on the size of the audit company, a cap based on a multiple of audit fees, and systems of proportionate liability.
- The independent study prepared by the EU concluded that: "The key issue in terms of reduced risk for audit firms and increased competition by the audit firms is not so much the precise form of the limitation as the level of liability that firms face in a regime in which auditors' liability is limited. A relatively high limit may be appropriate for the Big Four firms as it serves as a potential incentive to focus on audit quality but may not result in significant entry of middle-tier firms into the audit market served by the Big Four firms. Conversely, a liability limit which is low enough to encourage middle-tier firms to audit larger companies may not provide the appropriate incentives to the Big Four firms".

Evaluation of provisional recommendation

- *Effectiveness:* The implementation of the new Companies Act provisions in the UK, and possible changes to liability arrangements in other countries, could be an important factor in future decisions by firms as to whether to offer audit services to public interest entities. This may depend, however, on new arrangements leading to the expansion of the insurance market for major audit firms, which is not certain.
- *Quality:* Those developing and implementing policy can be expected to consult widely to help ensure that audit quality is protected.
- *Cost:* Some potential to lower risks for audit firms, or at least make risks more predictable and hence manageable, but difficult to assess at this stage.

A.1.4 More accurate perceived capabilities of non-Big Four firms

Current market characteristics

- The Oxera study found that many stakeholders perceived there to be significant differences between the capabilities of the Big Four and non-Big Four firms. However non-Big Four firms have suggested that there are misconceptions in the market over their capabilities.
- Non-Big Four firms have suggested that these misconceptions are amplified as the auditing members of regulatory standard setters come predominantly from Big Four firms.
- Within the UK, both the Accounting Standards Board (ASB) and Auditing Practices Board (APB) currently do not have practising members who are from large non-Big Four firms. Significant aspects of the regulatory policy for corporate reporting and governance are now decided or heavily influenced by European or global organisations. Among these organisations, the International Accounting Standards Board has one practising member, who is from a Big Four firm, and the International Auditing and Assurance Standards Board has seven practising members, of which one is from outside the Big Four.

Effects of current market characteristics

- Companies which wish to benefit from expertise on accountancy regulation may assume that they need to deal with the Big Four. As a result non-Big Four firms are less likely to be considered as credible candidates for public interest entity audits.

Characteristics of a more efficient market

- Non-Big Four firms act to reduce misconceptions in the market over their capabilities.
- Those purchasing or influencing the purchase of audit services are better informed as to the capabilities of both non-Big Four and Big Four firms.
- Regulators reduce misconceptions in the market by ensuring greater involvement of non-Big Four firms in regulatory standard setting.

Selected views from responses to the FRC's 2006 discussion paper

Audit firms should communicate their capabilities more effectively to the market and be specific about which market segments they choose to operate in. It is for organisations such as Grant Thornton International to boost their levels of brand awareness and international reach among their target audience. *Grant Thornton*

FRC should be encouraging proactively through its operating boards those firms which are not as large as the Big Four to enhance their services and actively to demonstrate their "strength on the bench" in order to enable them to be more active players in the corporate auditing market, particularly among FTSE100 companies. International reach and research arms to keep them ahead of and abreast of new regulation seem to be the key capabilities that are lacking at the moment. *Institute of Chartered Secretaries and Administrators*

[Steps should include] ensuring appropriate involvement of "non-Big Four" firms in regulatory and standard setting bodies, thereby both reducing their reliance on the "Big Four" firms and ensuring that "non-Big Four" firms have knowledge of the agendas of these bodies. This would also help address concerns expressed by some that the best (if not the only) way for a company to have access to this information is by having a "Big Four" firm as auditors. *BDO Stoy Hayward*

We also believe that regulators could help by ensuring that their policies are not tilted towards the business model of the large firms. The means recognising the role of medium-sized firms and consciously engaging them in the regulatory debate. The greater the risk of regulatory capture, the more consciously it must be fought. *ABI*

A.1.4 More accurate perceived capabilities of non-Big Four firms (ii)

Provisional recommendation 4

- Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms.

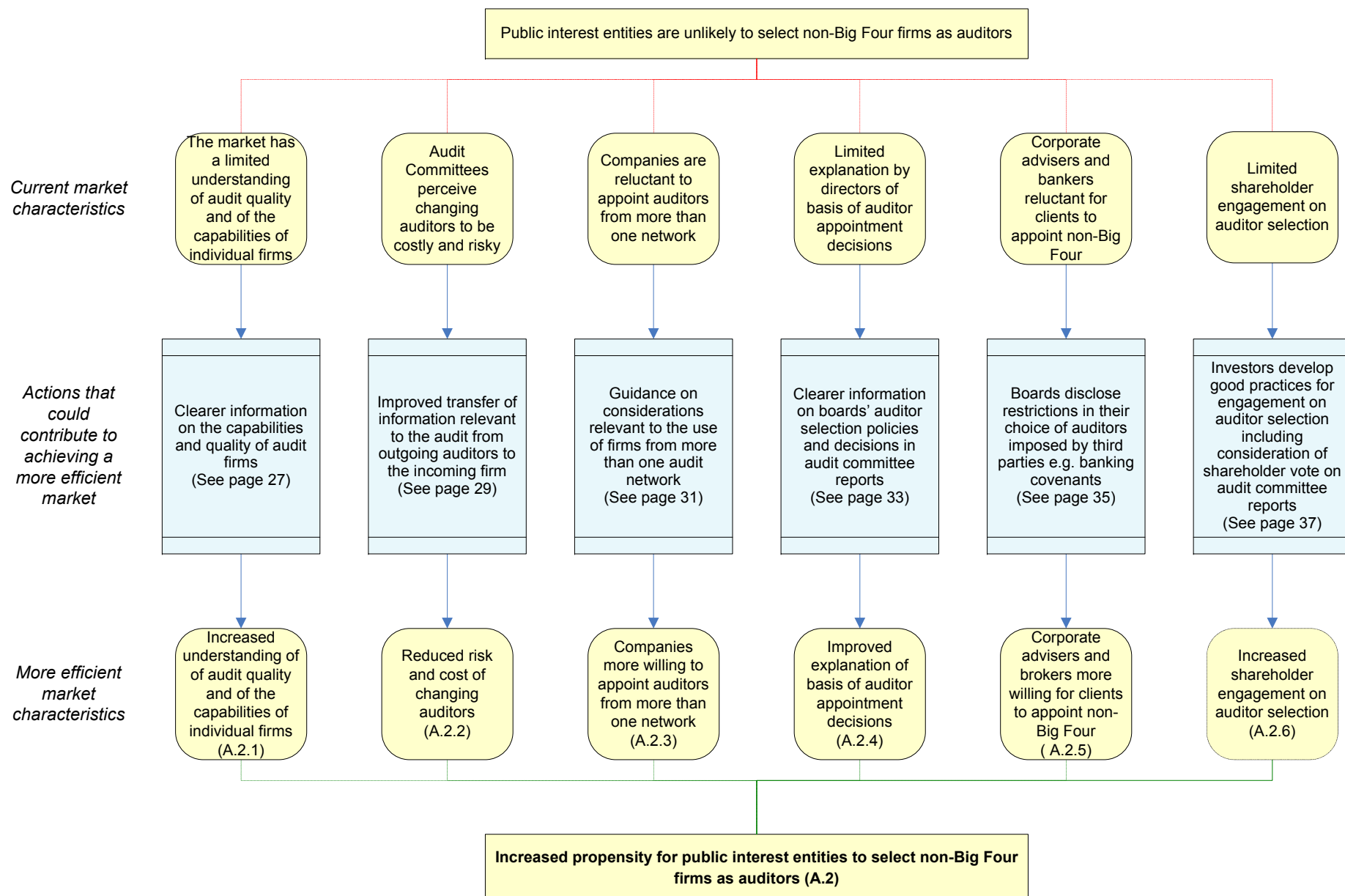
Commentary on provisional recommendation

- The primary responsibility for ensuring that the capabilities of the non-Big Four firms are more accurately perceived is with the firms themselves, who will need to invest to achieve this. The Group's focus in this area has been on whether there are factors largely outside of the control of the non-Big Four firms that might contribute to an inaccurate market perception of the firms' capabilities.
- The Group recognised that regulatory bodies and committees in the UK do involve non-Big Four firms in their work in various ways. The ASB does have 3 non-Big Four members on its Urgent Issues Task Force. It also holds quarterly meetings with the technical partners of 11 firms. While not a formal part of the standard-setting process, it is a forum for the firms to get involved and share views. The APB also uses a group called the 'Technical Advisory Group' made up of technical partners of the largest 20 audit firms to obtain views on issues and to populate certain of its working parties. However this involvement by the non-Big Four may not be as clear as that of the Big Four and this could contribute to possible confusion over the capabilities of the different firms.

Evaluation of provisional recommendation

- *Effectiveness:* This provisional recommendation would help to reduce a particular source of possible confusion about the capabilities of non-Big Four firms that is largely outside of the control of the firms themselves.
- *Quality:* Members of the APB and ASB are appointed based on their individual expertise rather than as representatives of their organisations. No change to this policy is proposed. Wider participation on these and other regulatory bodies and committees should also help to ensure that regulatory decisions are well informed.
- *Cost:* Participation in standard setting bodies and committees can involve a significant investment of time. However non-Big Four firms would be free to decide whether they wished to incur the cost of involvement in standard setting.

A.2 Increased propensity for public interest entities to select non-Big Four firms as auditors - Summary



A.2.1 Increased understanding of audit quality and of the capabilities of individual firms

Current market characteristics

- The Combined Code on Corporate Governance recommends that audit committees assess the effectiveness of the audit process. They do so by considering aspects such as the audit team, quality processes, audit scope, communications, governance and independence. The Oxera study referred to audit as an ‘experience good’, whereby companies develop an understanding of the quality of the audit product they receive over a period of time.
- It is difficult for company management and audit committee chairs to comprehensively and objectively assess the quality of the service they receive from their own auditor, and especially difficult to assess the likely quality of service that could be expected from another firm. Shareholders have very little information on which to base any assessment of quality of auditors. There is also currently no single agreed definition of ‘audit quality’.
- Finance directors and audit committee members may have experience of working with some (now) Big Four firms, but often not the non-Big Four. There is also no single agreed definition of audit quality that can be used as a ‘standard’ against which firms can be assessed in the absence of direct experience of working with them.

Effects of current market characteristics

- Oxera found that many audit committee chairs said they did not know the non-Big Four firms very well. Difficulties in assessing audit quality result in a high dependence on the brand of an audit firm and its reputation in the process of auditor selection. Less than 10% of FTSE 350 companies surveyed by Oxera would have, at that time, considered using a non-Big Four firm.

Characteristics of a more efficient market

- A stronger understanding of the drivers of audit quality that can be used as a ‘standard’ against which the capabilities of different audit firms can be assessed.
- Improved and comparable information on firms, in particular relating to the drivers of audit quality.

Selected views from responses to the FRC’s 2006 discussion paper

It is in the interests of shareholders that company audit committees choose the most appropriate auditors, taking account of all factors, including experience of the sector, specialised technical knowledge and geographical coverage. *Group 4 Securicor*

Companies and their audit committees will only wish to purchase services from non-Big Four firms if they have sufficient trust in the quality of the services provided. A key issue here is to ensure that information is available to help companies to make considered choices. *CIMA*

We wish to emphasise that we fully accept it is our responsibility as a firm interested in further increasing our number of listed audit clients to ensure that potential clients are aware of the high quality services offered by us. *RSM Robson Rhodes*

Market competition might be improved if...regulations were introduced that required firms to justify industry specialist claims at the four-digit Standard Industrial Classification level. *Kevin McMeeking, University of Exeter*

We would welcome the Tier A firms, and indeed the Big 4 firms, explaining to shareholders the ways in which their service offering is different and will generate higher quality audits. *Hermes*

We also believe that greater transparency in reporting on audit inspections and reporting on positive aspects of how a firm operates rather than just issues and concerns could serve a significant role in helping companies, audit committees, investors and other advisors to better understand and evaluate the capability of audit firms. *BDO Stoy Hayward*

In recent years auditors have not engaged much with major shareholders. More commitment for engagement on matters such as the governance of auditing firms, their client profiles and the policy issues they face would help ensure that major shareholders are better informed and better manage their expectations. It would also help major shareholders clarify their preferences between auditing firms and in turn, they could make it clear, as a number have already done so, that they do not necessarily expect companies to select an auditor from one of the Big Four. *Investment Management Association*

A.2.1 Increased understanding of audit quality and of the capabilities of individual firms (ii)

Provisional recommendation 5

- The FRC should continue its efforts to promote understanding of audit quality and should promote greater transparency of the capabilities of individual audit firms.

Commentary on provisional recommendation

- Although it is largely for the firms to make the market aware of their capabilities and their potential to deliver high quality audits, there is a need to ensure that the information that is available in the market provides as accurate an indication of audit quality as possible and is comparable between firms.
- The Group noted existing initiatives that should contribute to an increased understanding of audit quality and of the capabilities of individual firms. These include the FRC's discussion paper on the drivers of audit quality, Promoting Audit Quality; the implementation of Article 40 of the revised EC 8th Company Law Directive requires firms to publish transparency reports which give information on the audit firm, including on the firm's structure, governance and systems for ensuring audit quality; and the development of enhanced information on the results of independent audit inspections carried out by the Audit Inspection Unit.

Evaluation of provisional recommendation

- *Effectiveness:* The availability of readily comparable information on key elements of audit firms' capabilities and quality has strong potential to meet the objective. There would need to be a commonly agreed definition of audit quality as the basis for the information. Firms would need to provide the information, either on a voluntary or regulatory basis.
- *Quality:* Measuring and reporting this information should promote audit quality.
- *Cost:* No significant effect.

A.2.2 Reduced risk and cost of changing auditors

Current market characteristics

- The Oxera study found that it was generally recognised by audit committee chairs, finance directors and audit firms that it takes time for a new audit team to develop a comprehensive understanding of a company's business.
- Several audit committee chairs commented to Oxera that the process of becoming familiar with the company can take up to two years, a period during which the company management will have to invest time in bringing the auditor up to speed.
- A variety of different arrangements occur in practice to facilitate the effective handover between the incoming and outgoing auditor. These include the exchange of letters, discussion between the incoming and outgoing auditors, the exchange of audit committee papers and minutes, and the shadowing of the outgoing auditor at key meetings such as the final audit committee meeting.
- It would however be extremely unusual for the outgoing auditor to share audit work papers with the incoming auditor due mainly to liability concerns. Firms also cite ethical issues and concerns over confidentiality of propriety audit methodologies.

Effects of current market characteristics

- Audit Committees perceive changing auditors to be costly and risky.
- The cost and risk associated with a change of auditors act as strong disincentives to changing auditors.

Characteristics of a more efficient market

- Information is more fully shared so as to reduce the perceived or actual cost and risk of changing auditors.
- Audit Committees perceive the cost and risk of changing auditors to be manageable.
- The cost and risk associated with a change of auditors do not act as strong disincentives to changing auditors.

Selected views from responses to the FRC's 2006 discussion paper

Changing audit provider is inevitably a costly process for both the client, in terms of the costs for the additional management time spent with the new auditors, and for the incoming audit firm, which has the challenging task of quickly getting up to speed with the client's business... Once appointed the new auditors have a huge task to acquire the detailed knowledge and understanding of the business, its systems, controls, risks and people which are normally acquired over a lengthy period by the incumbent auditor. Given the competitiveness of the audit market on the one hand and the priority given to delivering the highest quality audit possible we cannot see any options for reducing the cost of the transfer process or to minimise the risk for an incoming audit firm that has to get up to speed with a complex new client. *PricewaterhouseCoopers*

To facilitate...auditor changes when deemed appropriate by an issuer, regulators might also consider ways to facilitate the usage of a predecessor's working papers by a successor auditor so as to reduce the cost of change. *LIBA*

Consideration could be given to the development of a code of best practice... to encourage and facilitate auditor change. *CIMA*

There is a disruption to the finance function of companies with a change of auditor related to the new auditors "learning about us". It is hard to see how this can be significantly reduced without addressing some difficult liability issues. If outgoing auditors were required to pass on to their successors all (or specified pieces) or their documentation relating to, for example, their understanding of the client business, the analysis of risks, the audit approach and major audit judgements and papers presented to audit committees, without taking on any additional risk or liability in respect of how the new auditor uses it, auditor transition would be smoother for the new auditor and company alike. *Governance for Owners*

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. *KPMG*

A.2.2 Reduced risk and cost of changing auditors (ii)

Provisional recommendation 6

- The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.

Commentary on provisional recommendation

- Under the Companies Act 2006 auditors are required to provide a statement of circumstances connected with their ceasing to hold office. This provision is designed to provide a safeguard against the risk arising when auditors are changed due to disputes. The revised EU Statutory Audit Directive introduces a further requirement for the outgoing statutory auditor or audit firm to provide the incoming statutory auditor or audit firm access to all relevant information although how this would be achieved in practice has yet to be agreed.
- To facilitate sharing of audit files, the outgoing audit firms would want to be protected from litigation arising from both the reliance placed by the incoming auditor on subsequent audit opinions and from the company in relation to sensitive information held on the file. The profession would need to establish a mechanism within the existing law to facilitate such protection without affecting the outgoing auditor's responsibility in respect of opinions previously provided.

Evaluation of provisional recommendation

- *Effectiveness:* Further sharing of information could be an important part of reducing the barriers to changing auditor, whether that barrier is more perceived than real. It could also contribute to increased choice of auditor for major public interest entities from within the Big Four (see page 39).
- *Quality:* Sharing of information could increase audit quality by reducing the risk of errors in the period until the auditor is familiar with the company.
- *Cost:* Assuming that the outgoing auditor can be protected from litigation over the content of the file, the cost effect should be low.

A.2.3 Companies more willing to appoint auditors from more than one network

Current market characteristics

- Most international audit firms (both the Big Four and the non-Big Four) are structured as networks of independently owned and operated firms. The Big Four firms are generally perceived to have more extensive and more integrated networks than non-Big Four firms, including branding, common audit methodologies and quality standards, knowledge sharing and governance arrangements.
- The Oxera study noted that companies generally prefer to have the same audit firm across the countries where they operate, or into which they are planning to expand. Having one audit firm was associated with lower levels of risk.
- There is a perception in the market that auditing standards discourage the use of auditors from more than one network. The draft group auditing standard ISA600 states that although other auditors may perform work on the financial information of components for the group audit, the group auditor alone is responsible for the audit opinion on the group financial statements. The ISA does not impose differing obligations on the group auditor when using the work of firms from other audit networks as compared to firms from within the auditor's own network. It does however recognise that this may be a relevant factor in determining the depth of the group auditor's understanding of the other auditor. This depth of understanding, together with the risk associated with the particular component, are factors in determining the extent and nature of the group auditor's involvement in the work performed by other firms.

Effects of current market characteristics

- Audit committees are unlikely to consider using audit firms from more than one network.

Characteristics of a more efficient market

- Audit committees of growing companies using non-Big Four firms do not automatically appoint Big Four auditors when their activities expand geographically.
- Audit committees seek to appoint auditors for individual components of the group financial statements based on how best to achieve audit quality for that particular component and for the group as a whole.

Selected views from responses to the FRC's 2006 discussion paper

A significant barrier to new entrants in the large company audit market is the presumed need to have a large and well-integrated global network, which only the largest firms possess. The role of such a network in the audit of a multinational is primarily to undertake the statutory audits of subsidiaries....It is entirely feasible, and to a limited extent sometimes already happens, for a firm to audit the consolidated accounts of a multinational company, undertaking whatever work at local level is necessary for that purpose, while another firm or firms perform some or all of the local statutory audits. (While this might appear to duplicate cost, in practice the effects are mitigated by the fact that the group auditor will be selective in the work done and the company is free to choose lower cost providers in individual locations.) *Independent Audit*

Increasing the propensity of non Big 4 or new firms to seek to participate in the audit market for large companies could be encouraged by a modification of Auditing Standards to make it easier for the audit of large groups of companies to be undertaken by more than one firm. The trend in recent years has made it increasingly costly and unusual to have an audit structure where any audit work is undertaken by firms other than a group's primary auditor. *The Hundred Group of Finance Directors*

Another way to increase the participation of firms other than the Big Four in the audits of FTSE 350 companies would be to encourage the involvement of other firms in the audits of subsidiaries of such companies. There are many subsidiaries which other firms have the capability and resources to audit. However, current trends are towards having a single auditor across a whole large group. *PKF*

It is entirely feasible, and to a limited extent sometimes already happens, for a firm to audit the consolidated accounts of a multinational company, undertaking whatever work at local level is necessary for that purpose, while another firm or firms perform some or all of the local statutory audits. *Grant Thornton*

In our opinion, joint audit - where two firms with equal roles in the audit jointly form an opinion on the financial statements of a group - would be a potential solution with strong appeal. Joint audits are a tested and simple mechanism with negligible 'side effects'. Joint audit has proved to be effective in establishing deeper competition in France and India.

Mazars

A.2.3 Companies more willing to appoint auditors from more than one network (ii)

Provisional recommendation 7

- The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.

Commentary on provisional recommendation

- The Group has placed great emphasis on not making recommendations that could damage audit quality. It noted that the use of a single audit firm network is widely perceived in the market as helping to protect audit quality. It is recognised that in some situations the use of firms from more than one network might pose a threat to audit quality. However there may be occasions where it is possible that the use of firms from more than one audit network might help to protect audit quality. For example, for companies that currently receive a high quality audit from a non-Big Four firm who have expanded geographically, it is possible that audit quality could be maintained using a firm from a second audit network for some of the audit work. The decision is for audit committees to make and it is important that they can make this decision on a well-informed basis.
- The Group considered whether there is a need for revisions to auditing standards to facilitate the use of firms from more than one audit network, where the audit committee believed this to be the right way to achieve audit quality. As noted, existing or planned auditing standards are broadly neutral on whether audits should be carried out by firms from the same network. Where the group auditor plans less reliance on the work of an auditor from outside of its own network or where differences in audit methodologies require additional procedures there can be some adverse cost implications through the duplication of audit effort. The group auditor should be able to justify this to the audit committee on the basis of delivering audit quality rather than attributing this as a specific requirement of auditing standards. Any guidance prepared should recognise relevant regulation including ISA600 (see previous page).

Evaluation of provisional recommendation

- *Effectiveness:* Independent guidance might lead to some audit committees considering the use of auditors from more than one audit network.
- *Quality:* The guidance would help audit committees to identify how to protect audit quality, including the identification and mitigation of risks that are inherent in the different types of auditor appointments.
- *Cost:* Although there may be some economies in using the same international network, there may also be cost savings from using non-Big Four networks for some parts of the audit. This would be for companies to negotiate and consider and should not be as significant a factor as achieving the highest audit quality.

A.2.4 Improved explanation of basis of auditor appointment decisions

Current market characteristics

- The Combined Code on Corporate Governance requires there to be a separate section in the annual report that describes the work of the audit committee in discharging its terms of reference. Some companies present this as a separate report; others include it as a section within their Corporate Governance report.
- Most companies surveyed by Oxera put their audit out to tender at most once every five years. There are examples of companies having used the same audit firm for decades. While such arrangements might be entirely consistent with audit effectiveness, few audit committee reports describe in any detail the policy adopted by the audit committee on auditor tendering and switching.

Effects of current market characteristics

- In the absence of information on the basis of the auditor appointment decision, investors tend not to discuss auditor selection with audit committees.
- Without shareholder engagement, there is a risk that companies and audit committees may not fully consider how best to achieve audit quality through their auditor selection decisions.

Characteristics of a more efficient market

- Investors are better informed on the basis of auditor appointment decisions, giving them a basis for engagement with audit committees and, where appropriate, seek to influence audit committees' auditor selection policies.

Selected views from responses to the FRC's 2006 discussion paper

Measures suggested have included...encouraging audit committees and board 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. *ICAEW*

Audit committees should make themselves available if necessary to explain to major shareholders any changes of auditor and consult them on the selection of an alternative from a wider range of firms. *Investment Management Association*

If over the next few years there is seen to be no change in patterns of tendering for audit and in engagement of a wider range of firms particularly among the FTSE 250 companies there may be a case for light touch regulation, possibly in areas such as a 'comply or explain' approach to tendering. *Institute of Directors*

Useful improvements flowed from the Smith Report. However, there is scope for further improvement in the context of auditor change. In particular, the following improvements should be made: When an auditor is due to be changed, the audit committee should communicate with the company's major investors to explain the reasons for the change...When an auditor is changed there should be a timely regulatory disclosure of the change and of the process which was followed to select the new auditor. The process should be disclosed in sufficient detail to provide investors with a useful understanding of how the audit committee fulfilled its responsibilities. *Standard Life Investments*

Audit committees of listed companies should be encouraged to disclose in their annual corporate governance reports how they have complied with the provision in the Combined Code on Corporate Governance which calls on them to review the effectiveness of the audit process. Where companies have not put their audit out to tender for, say, the last seven years they should also be invited to indicate when this last occurred and why they believe this is not needed. We would, of course, fully recognise that when an audit is put out to tender the company may wish to reappoint the incumbent auditors. Where a listed company does put its audit out to tender there may be merit in asking it to disclose which firms were invited to participate in the tender process. The additional information proposed would enable investors to ask more searching questions of audit committees on issues relating to choice in the audit market. *RSM Robson Rhodes*

A.2.4 Improved explanation of basis of auditor appointment decisions (ii)

Provisional recommendation 8

- The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.

Commentary on provisional recommendation

- The Group believes that the primary responsibility for the selection of auditors of public interest entities should remain with their boards but that boards should be more accountable to shareholders for those decisions.
- Few annual reports describe in any detail the policy adopted by the audit committee on auditor tendering and switching or provide information on the company's tendering history. It could be relevant for audit committees to report the basis of auditor selection decisions together with supporting information on tendering frequency, tenure of the incumbent auditor, and a breakdown of audit fees between group, parent company and subsidiaries. If tenders have been held it could be relevant to describe the range of types of firms that were invited to participate.
- Changes to the Combined Code or Smith Guidance would need to be approved by the Financial Reporting Council following public consultation.

Evaluation of provisional recommendation

- *Effectiveness:* If deemed appropriate a change to the Smith Guidance would result in greater transparency over the basis of auditor appointment decisions.
- *Quality:* Greater accountability of audit committees could lead to some companies reconsidering their choice of auditor and, potentially, finding an auditor more capable of delivering high quality. Boards would remain responsible for auditor selection and it will remain important that they avoid changing auditor without a reasonable expectation of this contributing to audit quality.
- *Cost:* The information could be produced and published at low cost. Tenders can be expensive for companies and audit firms. There is a risk that companies could come under pressure from some shareholders to put their audit out to tender at set frequencies, even if the quality of the audit was felt to be strong. Any change to the frequency of tenders should, however, be for companies to judge based on their assessment of the costs and benefits applicable to their circumstances.

A.2.5 Corporate advisers and brokers more willing for clients to appoint non-Big Four

Current market characteristics

- Non-Big Four firms have provided examples of cases where advisers have recommended or required the use of a Big Four firm. In particular, banks may impose conditions prior to issuing loans, or as part of loan covenants.
- It has been suggested that this intervention by advisers and bankers may be poorly informed and arguably inappropriate.

Effects of current market characteristics

- The non-Big Four believe this to be a factor limiting their opportunity to be considered by growing companies. One firm pointed out that for a public interest entity to decide to appoint a non-Big Four is often a challenge in itself, and it does not take much for the companies to revert back to their 'comfort zone'.

Characteristics of a more efficient market

- Where advisers do exert influence over auditor selection, this is based on a well-informed judgement of the appropriateness of different audit firms to the needs of their client.
- Where advisers exert influence the rationale for this is explained to the client.

Selected views from responses to the FRC's 2006 discussion paper

We believe that the DTI, or the competition authorities, could investigate the inclusion of clauses in various banking, investment and other such agreements which require a company to have a "Big Four" firm act as auditor and determine the extent to which such clauses are appropriate or may be anti-competitive. *BDO Stoy Hayward*

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. *Morley Fund Management*

Another area, which would merit competition authority attention, is covenants in loan contracts. A loan covenant that requires a company to have a Big Four auditor may have the effect of limiting competition, even if it is not intended to do so. *ABI*

As far as LIBA members are concerned, investment bankers are usually not involved in the choice of an auditor by a large issuer. However they are sometimes involved in a discussion regarding the choice of a reporting accountant in a security offering scenario, and in such cases it would be possible to suggest or consider other firms in addition to a non-Big Four firm as a reporting accountant. Over time, recognition of such a firm's performance as a reporting accountant for new issues could lead to more appointments as auditor. *London Investment Banking Association*

Lawyers, bankers and other advisers have no direct locus in the appointment of auditors but do have the opportunity to influence directors who are making such appointments. Probably it is the usual stance and influence of investment bankers in relation to companies contemplating fund raising or major transactions involving shareholder circulars that provides the most significant barrier for non-Big Four firms from advisers. Such attitudes are only likely to change if the bankers are convinced that a non-Big Four firm is behaving differently from the recent past so as to allow the banks to believe that such attitudes are no longer valid. *Governance for Owners*

A.2.5 Corporate advisers and brokers more willing for clients to appoint non-Big Four (ii)

Provisional recommendation 9

- When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.

Commentary on provisional recommendation

- It is not clear that loan covenant or other requirements to use certain audit firms are inherently unreasonable. A bank that is placing its assets at risk should have some say as to how those assets are protected. Therefore the Group was not minded to suggest that banks or other corporate advisers should not be able to advise their clients on the use of particular audit firms.
- Many banks have good working relationships with a wide range of auditors and there is evidence that banks are willing to reconsider their position if approached by a non-Big Four firm. Nonetheless, it does appear that some bankers and other advisers have a policy of recommending only the use of only Big Four firms. Such policies might result in the clients not being free to select the most appropriate auditor for their needs.
- Section A.2.4 identified the need for improved explanation from Boards of auditor appointment decisions. In cases where advice or requirements from corporate advisers and bankers formed an important part of the Board's decision then it would be relevant for this to be explained to shareholders. This might lead to a more open discussion over the advisers' advice or requirements leading, where appropriate, to market pressure on the advisers or banks to change their position.

Evaluation of provisional recommendation

- *Effectiveness:* The non-Big Four firms will need to promote their capabilities more effectively to influence corporate advisers and bankers. However it could also be helpful for advisers and bankers to accept responsibility for ensuring that the advice they give to clients in this area is well informed and explained.
- *Quality:* No significant direct effect.
- *Cost:* No significant direct effect.

A.2.6 Increased shareholder engagement on auditor selection

Current market characteristics

- There is only very limited direct communication between companies and investors regarding auditor selection. Audit committees and company management tend to assume that shareholders prefer Big Four firms.
- The Investment Committee of the Association of British Insurers released a statement in June 2006 encouraging companies to have an open mind and consider all choices when appointing auditors. A group of six investment management organisations wrote to audit committees along similar lines.
- Shareholders vote on the reappointment of auditors each year but it is very rare for there to be any discussion between investors and audit committees over the reappointment decision.

Effects of current market characteristics

- Audit committees and company management seek to prevent criticism by shareholders of their audit selection decision by hiring a Big Four firm – the ‘IBM effect’.
- Shareholders tend to assume that there is no need to pay particular attention to companies’ auditor selection policies and decisions other than in exceptional circumstances.

Characteristics of a more efficient market

- Investors engage with companies over auditor selection policies and decisions.
- Audit committees and company management take appropriate account of the views of their shareholders on auditor selection policies and decisions.

Selected views from responses to the FRC’s 2006 discussion paper

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. *The National Association of Pension Funds*

Investors can...help by making it clear that they do not necessarily object to the selection of an auditor from outside the Big Four. The ABI has recently issued a statement clarifying this after it became clear from the Oxera Report that audit committees are tending to second-guess the views of investors and are too pessimistic about investors’ likely reactions to a choice outside the top-tier. We made it clear in the statement that investors are willing to engage with audit committees on the question of audit choice. *Association of British Insurers*

It is the views of the investor community which are the most important to this consultation. As end users of financial reports, their input is of great importance. They can inject impetus to the debate by providing comfort to audit committee chairs that it is ‘safe’ to appoint a non-Big Four auditor. The statement from the ABI to this effect is a very welcome milestone, but alone it is not sufficient. We urge other investors to make their views known. Investor groups should begin to challenge publicly the audit appointments of large listed companies, as such ‘activism’ can shape the future direction of the debate. *Grant Thornton*

The Combined Code should be amended to require a shareholder vote on the report of the audit committee similar to the vote on the remuneration committee report. We believe that this would allow shareholders to call for meetings with the audit committee chairs of companies where the shareholders considered circumstances warranted it. Such meetings between shareholders and remuneration committee chairs have had a significant impact upon the behaviour of listed companies in relation to executive remuneration. *Governance for Owners*

Major investors should identify a principal point of contact to whom audit firms and companies can focus their engagement [regarding the election or re-election of auditors]. Such a ‘point person’ should be competent to engage responsibly on auditing matters. Investors should adopt, disclose and implement policy guidelines regarding their approach to auditor selection by companies and to voting on auditor-related resolutions at shareholder meetings. The Institutional Shareholders Committee should consider incorporating relevant provisions in its Statement of Principles to give authoritative encouragement to investors to take these steps. *Standard Life Investments*

A.2.6 Increased shareholder engagement on auditor selection (ii)

Provisional recommendation 10

- Investor groups, corporate representatives and the FRC should develop good practices for shareholder engagement on auditor appointment and re-appointments and should consider the option of having a shareholder vote on audit committee reports.

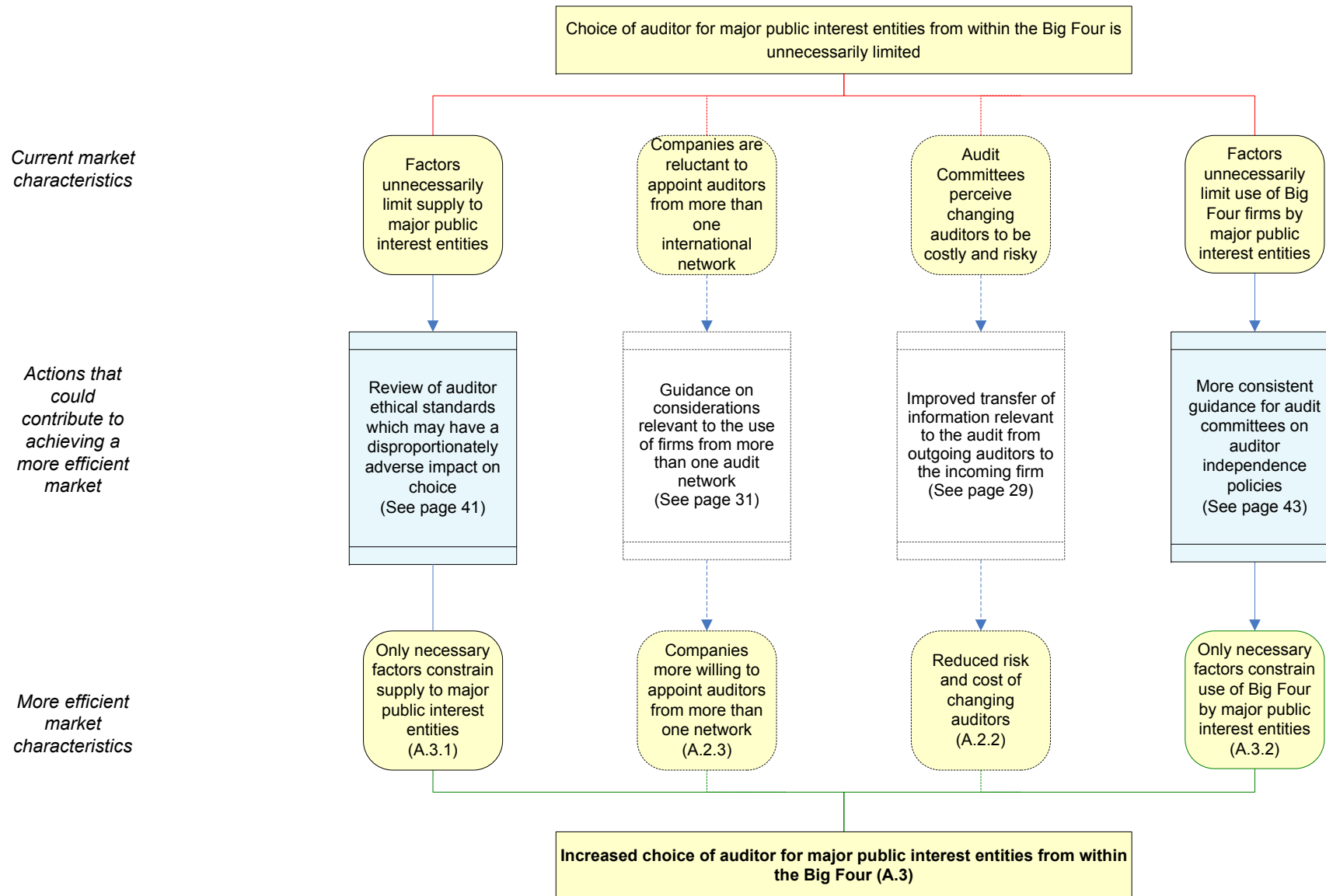
Commentary on provisional recommendation

- The Group noted that there is currently an advisory (non-binding) vote on remuneration committees' reports on executive remuneration policy. The vote is seen as having increased dialogue between investors and companies on remuneration issues.
- To help overcome the existing limited level of communication between shareholders and audit committees on auditor selection, the Group considered that there was merit in evaluating options for enabling shareholders to vote on audit committee reports. Options could include a vote being either binding on the company, in which case it might be on a report that concluded with a recommendation on auditor reappointment or replacement, or it could be advisory, in which case there would remain a separate vote on auditor reappointment or replacement. It is recognised that the effects of a binding vote against acceptance of the audit committee's report could leave the company in a difficult situation, although this would only happen in extreme circumstances. Other options might relate to the frequency of the vote. It would be important that shareholders use any new voting powers carefully to avoid pressure on audit committees to put audits out to tender merely as a 'box-ticking' exercise.

Evaluation of provisional recommendation

- *Effectiveness:* Representatives of investor groups have supported, in principle, the introduction of a requirement for Boards to provide greater information about the reasons why they have selected a particular auditor on the terms agreed, as envisaged in A.2.5 (page 35). For there to be effective shareholder engagement, there is also a need for investor groups to provide greater information to companies on their views on how auditors should be selected. A vote could provide a useful basis for Boards and investors to discuss auditor selection policies.
- *Quality:* No direct effect.
- *Cost:* Increased shareholder engagement might lead to more tendering activity, which can be costly for both companies and audit firms. However this should only happen in circumstances when shareholders deemed it appropriate, which would suggest that there is a realistic chance that the tender would result in a change of auditor that would be beneficial, primarily in relation to audit quality but also, possibly, audit cost.

A.3 Increased choice of auditor for major public interest entities from within the Big Four - Summary



A.3.1 Only necessary factors constrain supply to major public interest entities

Current market characteristics

- Auditors are required to conduct audits with integrity, objectivity and independence. Standards and guidelines issued by the Auditing Practices Board in the UK include specific circumstances arising out of the financial, business, employment and personal relationships with the audit client; long association with the audit engagement; and non-audit services provided to audit clients.
- The US SEC rules in these areas are generally more prescriptive than UK rules or those of the International Federation of Accountants, particularly in the area of financial and business relationships with the audit client. For example audit team members can hold bank accounts with audit clients under both APB and SEC rules, but the SEC rules limit the accounts to those with balances below government insured limits, with the implications of this varying across the different countries in which audit team members hold the accounts.

Effects of current market characteristics

- US independence rules impact directly on UK companies that are listed in the US and may apply more widely as firms, when developing an international approach to independence, standardise on the most prescriptive (i.e. US) requirements on a global basis. The rules can make auditor changes for financial institutions particularly difficult.
- There are concerns that ethical standards, particularly those of the US SEC, are causing an adverse impact on choice that is disproportionate to the benefits to auditor objectivity and independence. Some are concerned that the UK rules requiring audit partners for listed companies to be rotated every five years could act as a disincentive for companies to change auditors, because there is a need to consider not only the audit partner proposed for an audit but also the firm's ability to find a replacement partner in five years' time.

Characteristics of a more efficient market

- Auditor independence rules are set at the level necessary to protect audit quality hence avoiding unnecessary constraints on audit choice.
- Auditor independence rules are generally consistent in major markets.

Selected views from responses to the FRC's 2006 discussion paper

The standards of corporate governance compliance and independence criteria are very high – maybe some reduction in this area would be helpful and should be investigated. We accept that the likelihood of this being achieved for companies with a US listing is likely to be extremely remote. *The Institute of Chartered Secretaries and Administrators*

It is worthy of note that some of the restrictions on choice are themselves the result of regulation imposed on the firms which prevents them from offering audit services to clients to whom the firm concerned provides certain prohibited non-audit services. We do not contend that any of these restrictions are unreasonable but point out that in practice the delivery of one policy goal can have repercussions in other areas. None of these issues can therefore be viewed in isolation. *PricewaterhouseCoopers*

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. *KPMG*

The provision of non-audit services to audit clients can lead to cross-subsidisation and underbidding for “foot in the door” opportunities. Thus it can create a barrier for smaller firms that do not have the capacity to provide such a wide range of services. IMA would not support such services being prohibited and considers there is a case for restricting them. *Investment Management Association*

A.3.1 Only necessary factors constrain supply to major public interest entities (ii)

Provisional recommendation 11

- Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.

Commentary on provisional recommendation:

- Those responding to the consultation, particularly companies and banks, might wish to comment on the degree to which the most prescriptive auditor independence rules may limit their choice of auditors and whether, in their view, the rules are more prescriptive than necessary to maintain audit quality.
- The FRC's Auditing Practices Board is planning to undertake a review of the ethical standards for auditors this year. Given the extent to which such matters have been the subject of recent and extensive consultation, and the need to maintain as consistent approach as possible within Europe, major changes are not expected, however it is feasible that it could take the opportunity to review the rotation policy.
- The Government accepted the recommendation by the Coordinating Group on Audit and Accounting Issues (CGAA) in January 2004 to reduce the timescale for the rotation of the lead audit partner from seven to five years. The MPG discussed whether this rule might be relaxed for one or two years either in all cases, or in specific circumstances such as where there had been a change in Finance Director or audit committee chair. Alternatively companies might be able to agree an extension from 5 to 7 years provided it is explained in the Audit Committee report.
- In recognition of the effects of independence rules in other countries on the UK market, the FRC could consider whether it can influence foreign regulators in a way that encourages a re-evaluation of these rules.

Evaluation of provisional recommendation

- *Effectiveness:* Changes to the number of suppliers of audits of the largest public interest entities are unlikely other than in the long term. In the meantime, choice might be improved through changes to independence rules. However more information is needed from market participants to help the FRC and other audit regulators to consider whether the existing rules are set at the minimum level necessary to protect audit quality so as to avoid unnecessary constraints on audit choice.
- *Quality:* Any changes to the rules would only be made once it was clear they would not be detrimental to quality.
- *Cost:* No impact.

A.3.2 Only necessary factors constrain use of Big Four by major public interest entities

Current market characteristics

- Many companies which use a Big Four firm as auditor also choose to use other Big Four firms for non-audit work.
- The Smith Guidance on Audit Committees guidance suggests that the audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The Guidance requires the audit committee to ensure that there is no threat to auditor objectivity and independence.
- The standards and guidance of the Auditing Practices Board (APB) describe how appropriate safeguards can be put in place to mitigate the risks to auditor objectivity and independence from the provision of non-audit services by the auditor.

Effects of current market characteristics

- Some Boards adopt policies on the provision of non-audit services by the auditor that are more conservative than those suggested as necessary by the APB guidance. This can make it more difficult for the firms used for non-audit work to be considered for audit work.
- Some audit committees may have developed more conservative policies because they consider them appropriate, whereas others may have done so only because they believe them necessary to meet the Smith Guidance.

Characteristics of a more efficient market

- In developing policy on the provision of non-audit services by the auditor, audit committees have clear guidance that is consistent with the guidance issued to the audit firms.

Selected views from responses to the FRC's 2006 discussion paper

For those who choose to use the Big Four for audit, it may be a sensible strategy to avoid the use of one of two Big Four firms (in addition to their existing auditor) for those services that would preclude their ability to compete for the audit. This may result in more use of the non-Big Four organisations for those services that would prohibit competing for the audit. This will benefit companies and the markets by providing more auditor choice and potentially strengthen the overall market share of the mid-tier firms relative to the Big Four. *Ernst & Young*

...We operate in over 100 countries and only a limited number of audit firms are capable of providing services across that number of territories. In addition, auditor independence rules reduced the potential candidates. *Group 4 Securicor*

In practice a combination of factors, including the rules on auditor independence and the desire of competitors in the same industry to have different auditors, limits the choice that large companies have. The choice of auditors is considerably more restricted than the choice of providers for other professional services that large companies tend to buy. *100 Group of Finance Directors*

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. *ICAS*

A significant impact on choice also comes from the conflicts of interest arising from the provision of non-audit work. We do not believe it is practical to prevent auditors undertaking non-audit work. Instead we have always supported a governance approach whereby the audit committee should demonstrate that it takes account of conflicts in letting such work so as to ensure that the auditor remains independent. As a practical measure we believe that non-audit work should be spread widely through the market and investors should be vigilant in ensuring that audit committees have proper tendering processes which do not compromise the independence of their audit. *ABI*

A.3.2 Only necessary factors constrain use of Big Four by major public interest entities (ii)

Provisional recommendation 12

- The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.

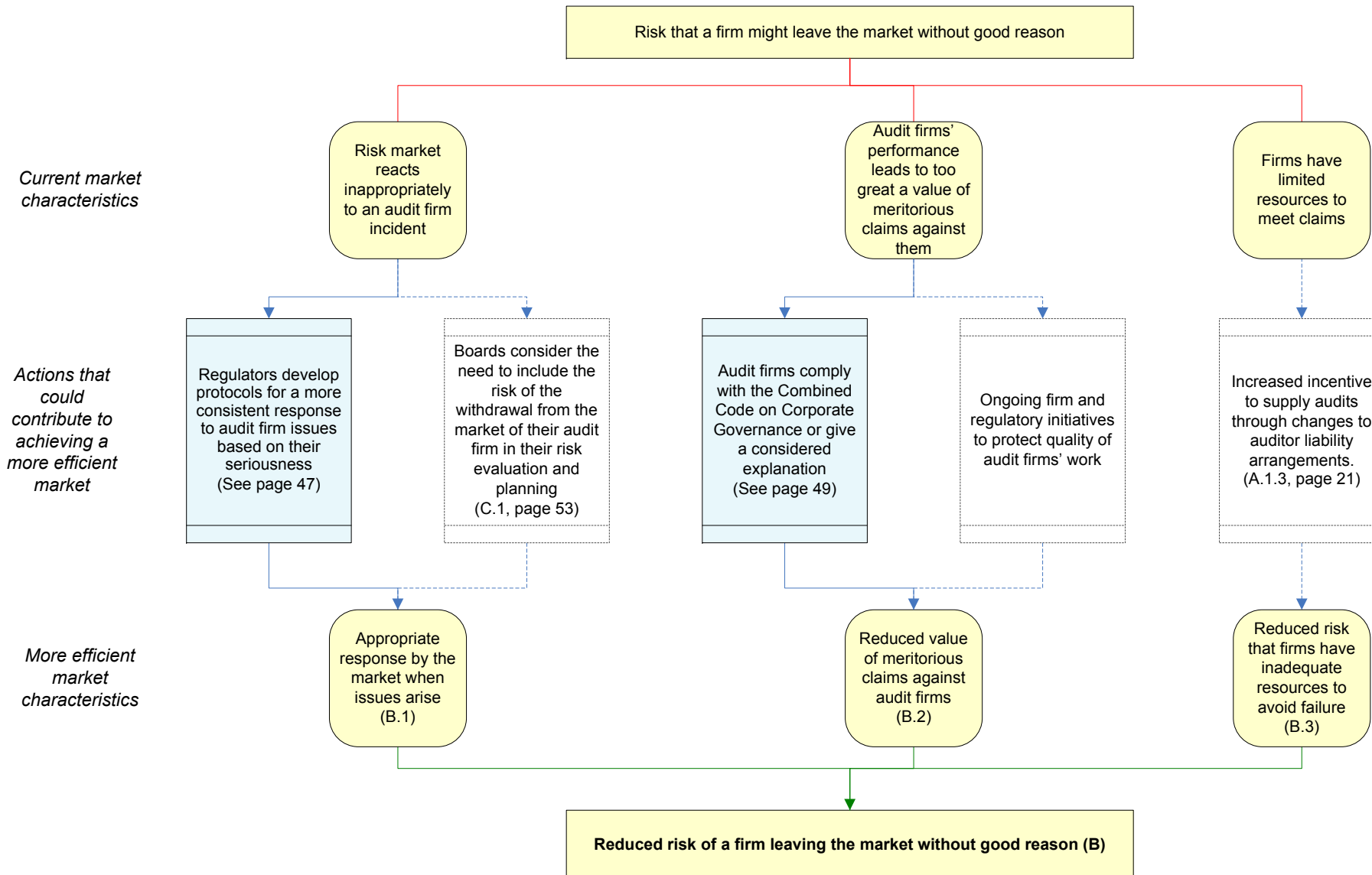
Commentary on provisional recommendation

- The Group's concern in this area has been over whether two sets of connected regulation could be interpreted in different ways.. It will remain for Boards to consider the most appropriate policy in relation to the provision of non-auditor services by the auditor, taking account of the guidance and any possible impact on auditor choice.
- Changes to the Smith Guidance would need to be approved by the Financial Reporting Council following public consultation.

Evaluation of provisional recommendation

- *Effectiveness:* Could help some companies to increase their choice from within the Big Four, should they consider this appropriate.
- *Quality:* No significant impact, as the relevant auditing standards and guidance would not change.
- *Cost:* No significant impact.

Summary for Objective B: Reduced risk of a firm leaving the market without good reason



B: Reduced risk of a firm leaving the market without good reason

B.1 Appropriate response by the market when issues arise

Current market characteristics

- When there is a suggestion of possible misconduct by an audit firm, or there are other issues affecting an audit firm, companies are likely to consider how seriously regulators will take the issue before deciding how to respond themselves.
- In general, the responses to rule breaches are difficult to predict. In the UK, the Accountancy Investigation & Discipline Board is the independent, investigative and disciplinary body for accountants in the UK. A Disciplinary Tribunal can impose fines against individual accountants or their firms as it considers appropriate or can remove auditing licences.
- Global regulators of the audit firms have various approaches to responding to rule breaches by audit firms.

Effects of current market characteristics

- The regulatory penalties on an audit network in response to rule breaches can be difficult to predict. This can lead to uncertainty over the fate of a firm that could be more damaging than the eventual penalties themselves.

Characteristics of a more efficient market

- The market reacts to audit firm issues with as much information as possible, including a reasonable level of clarity over any likely regulatory response.

Selected views from responses to the FRC's 2006 discussion paper

Where rules are breached, firms should clearly be accountable, but it is difficult to imagine a circumstance where it is fair for an entire firm to face collapse. Whatever a group of individuals at Andersen did, it was unjust for the whole network and the people employed in that network to pay the price. There is real merit in promoting a coherent European, and if possible global, regulatory approach involving sensible and proportionate reactions to rule breaches. There is responsibility on regulators not to overreact to particular circumstances. This must inevitably involve increased active dialogue and consistent actions between regulators. *Ernst & Young*

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. *KPMG*

The best way for any audit firm to ensure that its reputation is not at risk is to provide quality audits. It is to have talented, well-trained staff of an appropriate level carrying out those audits, and to ensure that the structures surrounding the provision of audits promote quality above other considerations. Audit firms' reputations have not been enhanced by their focus on mitigating liability issues to the exclusion of all else, including audit quality. *Hermes*

...regulators around the world should resist indicting an entire firm to punish the actions of a few...The costs of providing a proportionate regulatory regime should not be onerous. The better regulatory systems are based on principles promoting high standards rather than those based on detailed rule which are often too heavy-handed, expensive and relatively ineffective. *Deloitte*

It is highly debatable whether the disappearance of Arthur Andersen in 2002 was "unnecessary". Beyond the firm's involvement in high-profile cases such as Waste Management, WorldCom, and of course Enron, several studies have highlighted the degradation of the quality of its internal controls and of its collective ethics in the years preceding its demise. That even Paul Volcker was not able to save Arthur Andersen is an indication that it was a difficult case indeed. Generally speaking, it is not self-evident that significant public or collective efforts should be made to preserve audit firms which do not meet high standards of integrity. *Nicolas Véron, Bruegel*

B: Reduced risk of a firm leaving the market without good reason

B.1 Appropriate response by the market when issues arise (ii)

Provisional recommendation 13

- Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.

Commentary on provisional recommendation

- The Group considered that firms have the primary responsibility for ensuring that the market responds to an issue affecting them with full information. It recognised however that part of this information comes from regulators.
- It seems unlikely that the regulation of audit firms could ever be simplified to the extent that there is a simple list of crimes and punishments. The Group also recognises that the ability of different regulators to set out a 'scheme' of penalties may be restricted by law, and the ability of regulators in different countries to develop protocols is therefore limited.
- However there would appear to be benefits in some high-level description of the types of misconduct issues that might attract different types of regulatory responses. For example, how regulators would differentiate between an isolated issue in one office of a firm compared to a more systematic failure. Once clearer policy is established amongst individual regulators, this could form a useful basis for international cooperation and, eventually, a protocol to ensure consistency across regulators.

Evaluation of provisional recommendation

- *Effectiveness*: Could help to remove uncertainty over regulatory penalties, contributing to a well-informed response to audit firm issues by the market.
- *Quality*: No significant impact. Regulators would retain their ability to penalise the firms as they see fit, although their policies would become more transparent.
- *Cost*: No significant impact.

B: Reduced risk of a firm leaving the market without good reason

B.2 Reduced value of meritorious claims against audit firms

Current market characteristics

- Audit firms seek to avoid meritorious claims being made against them by delivering high quality audit and other services. The governance arrangements of audit firms contribute to the quality of these services. The firms describe their governance arrangements in their annual reports and have every incentive to make these arrangements effective.
- The UK's market-based approach to the regulation of corporate governance is based primarily on the Combined Code on Corporate Governance. The FSA's listing rules require companies to 'comply or explain' with the Code. The assessment of whether the company's governance practices are effective is made by the intended beneficiaries i.e. the shareholders.
- As partnerships, the UK audit firms do not have external shareholders and therefore do not provide information about their corporate governance on a 'comply or explain' basis.

Effects of current market characteristics

- Audit firms may not benefit from the system of checks and balances that is an integral part of the Combined Code, including the expertise and independent challenge that comes from independent non-executive directors and strong, independent audit and remuneration committees. As a result, it is theoretically possible that there is a higher risk that firms breach rules or deliver poor quality services. The firms argue however that their governance is strong, reflecting the extent to which their partners have their personal capital, reputation and future income at risk.

Characteristics of a more efficient market

- The governance of the audit firms takes full account of good governance practices identified in the Combined Code.
- Beneficiaries of audit services, including audit committees and shareholders, have information on which to assess the firms' governance practices.

Selected views from responses to the FRC's 2006 discussion paper

Andersen's withdrawal came about as a result of loss of confidence among its clients following some elementary internal breaches of sound practice, including over-reliance of the Houston office on one audit account. Two lessons can be drawn from this. The first is that the culture of large firms should be such that any particular aberration is seen as an exception rather than evidence that the whole firm is contaminated. The second, which follows from the first, is that audit firms should have proper internal controls which protect them against unnecessary risk and enable them to demonstrate that their culture is sound, that they do not run excessive risk and condone low standards of professional practice. *ABI*

In the UK context, such an outcome [effective governance and oversight of their global business activities] could, for example, be achieved by encouraging the UK firms' partnerships to adopt the Combined Code on Corporate Governance as it bears on how the firms are organised and administered....The Combined Code is applied to listed companies on a "comply or explain" basis so that shareholders can assess the quality of internal governance. However, as these major firms have no external shareholder, but many external stakeholders, our view is that it may be preferable that they should as a stronger rebuttable presumption be expected to apply all aspects of the Code and to report publicly that they have done so. *FSA*

The "Big Four" are immensely large firms in their own right, carrying out statutory duties and, therefore, have significant responsibilities to the business community. This responsibility is not however reflected in their governance structures or in the transparency of their reporting. *FTSE 100 chairman*

B.2 Reduced value of meritorious claims against audit firms (ii)

Provisional recommendation 14

- Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.

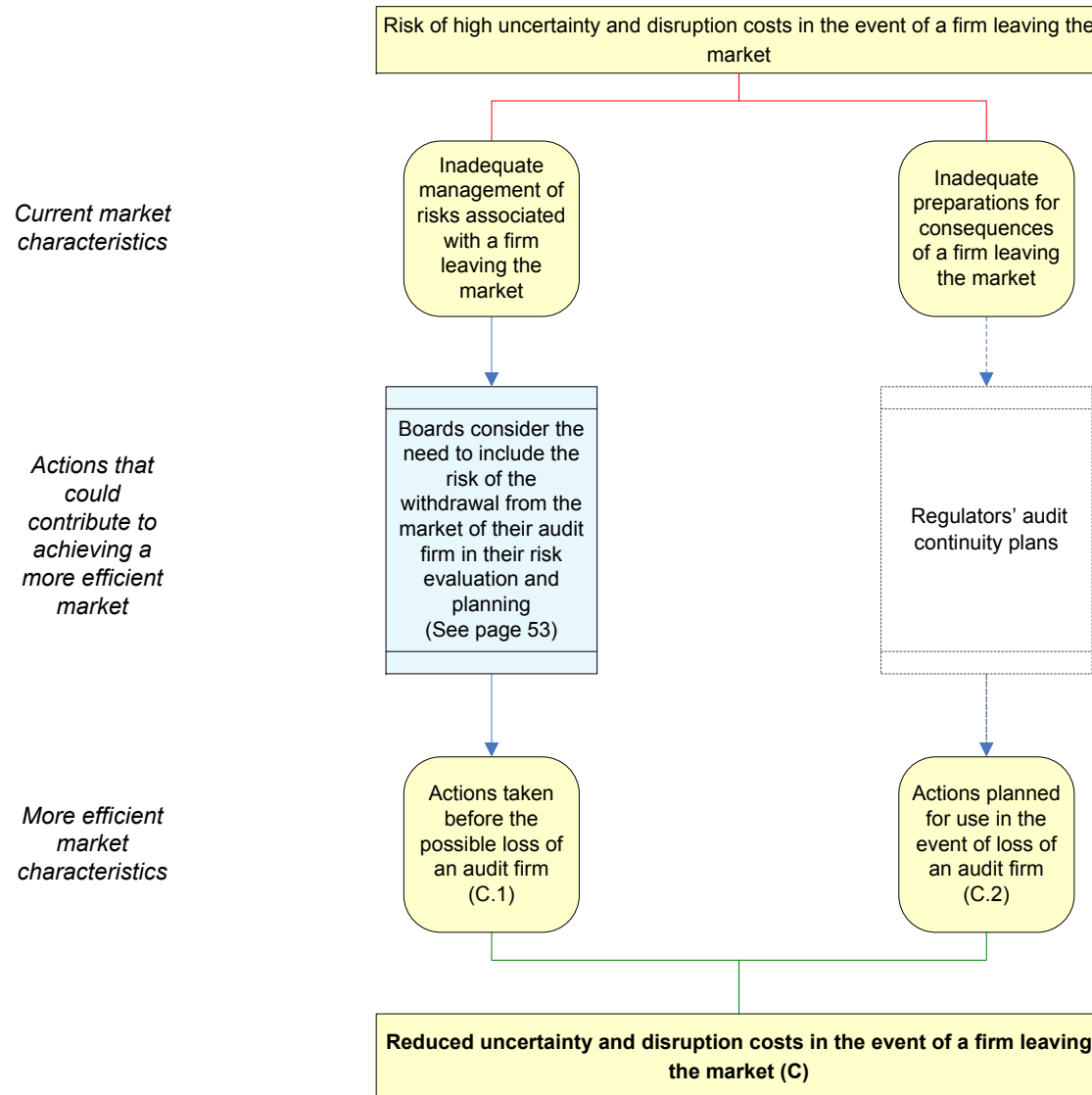
Commentary on provisional recommendation

- Although audit firms are not public companies, they operate in a market that is created by government and legislators and for which market entry is restricted to those with relevant professional qualifications and are subject to regulatory supervision. This situation brings with it a public interest responsibility to help ensure that there is a continued supply of independent and high quality audits. The Group considers, therefore, that just as the the UK regulatory framework provides shareholders of companies with information to enable them to make a judgement on the governance practices of the companies in which they invest, so should it provide users of audit services (that is, the shareholders of audit firms' clients) with information on the governance practices of the firms auditing public interest entities. Those responding to the consultation might wish to comment on what adaptations to the Combined Code, if any, might be appropriate.
- The revised 8th Directive on the regulation of statutory auditors requires that audit firms publish annually a transparency report including information on their structure, governance and systems for ensuring audit quality. Most large audit firms in the UK already voluntarily incorporate similar information within their annual reports. The information published is helpful but can be difficult to compare against the good practices identified in the Combined Code.
- In describing their governance arrangements, it would be appropriate for the firms to cover not only how they govern their activities within the UK but also how their international networks are governed.

Evaluation of provisional recommendation

- *Effectiveness:* The 'comply or explain' approach has been found to be very advantageous in the wider market and should have the potential to contribute to the reducing the value of meritorious claims against the firms.
- *Quality:* It is at least theoretically possible that enhanced market oversight of the firms' governance arrangements could lead to changes that help avoid risks to audit quality.
- *Cost:* The 'comply or explain' approach facilitates a pragmatic, market-based approach to the regulation of governance. There would be costs attached to compliance with the Combined Code, including appropriate remuneration to attract strong non-executive directors, but firms could choose to explain why they have not complied with the Code if they believed these costs to be disproportionate to the benefits.

Summary for Objective C: Reduced uncertainty and disruption costs in the event of a firm leaving the market



C.1 Appropriate response by the market when issues arise - Response by companies

Current market characteristics

- The Turnbull guidance requires boards to consider significant risks to the company achieving its business objectives and how they have been identified, evaluated and managed. The audit committee is responsible for monitoring the company's internal controls and risk management.
- Some companies already identify the risk of the withdrawal of their audit firm from the market as a risk. Others may not have considered doing so, or may (optimistically) believe that they can rely on regulators to mitigate the effects of the withdrawal of a firm.

Effects of current market characteristics

- Some companies might react to an audit firm incident without having considered all available information or options.
- Some companies might not evaluate options for how to mitigate the possible loss of their audit firm.

Characteristics of a more efficient market

- Directors of public interest entities consider whether to identify the possible withdrawal of their auditor from the market as a risk to the company achieving its business objectives.
- Directors of public interest entities evaluate options for mitigating risks arising from the possible withdrawal of their auditor from the market. If considered appropriate, they take selected actions to reduce the potential impact of the risk.

Selected views from responses to the FRC's 2006 discussion paper

Audit committees have a role to play in reviewing and assessing the risk of loss of their auditor and the risk of loss of a potential auditor. Regulated groups in particular, such as Friends Provident, have developed sophisticated risk management and risk monitoring processes over the past few years. The inclusion of this risk within that framework and the development of risk mitigation plans is a relatively straightforward action. *Friends Provident*

In the event of a problem arising with an audit firm, the regulators and the market would need to ensure provision of accurate and timely information to ensure that a firm did not fail on account of panic and/or misperception of the real situation. *CIMA*

Audit committees of client companies should...be expected to review their auditors' annual report annually and discuss concerns with the audit partner. Audit committees should be aware of the risk to their businesses if their auditor were to withdraw from the market. In the light of this they should be expected, perhaps via an addendum to the Combined Code, to develop a contingency plan, to identify one or more firms that could take over the audit if there was to be a disorderly withdrawal from the market, and perhaps even to state in the annual report that such a review had been conducted. *FSA*

The [Combined] Code should also require the inclusion in the audit committee report of a summary of the contingency plan a company has in place to deal with the possibility of its audit firm being unable to continue as auditor. We suggest that the effect of this recommendation combined with...a vote on the audit committee report would be to see realistic contingency plans being developed and the use of other firms for some work currently being done by the audit firm becoming a normal part of such plans. *Governance for Owners*

In terms of our own risk mitigation planning...we ensure that at any one time there are at least another two of the Big Four firms that could step in quickly in the event of our auditors collapsing. We also track major pending litigation against the Big Four....We have high-level discussions on an ongoing basis with another Big Four firm regarding taking on our audit on an emergency basis. Increasing the effectiveness of that planning would require a major exercise with the stand-by firm. We would only embark on this in the event of a major litigation or performance issue at our current auditor. *FTSE 100 finance director*

C.1 Actions taken before loss of an audit firm (ii)

Provisional recommendation 15

- Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

Commentary on provisional recommendation

- The Group considered that it was appropriate for all public interest entities, but particularly those who perceive their choice of auditor to be limited to the Big Four, to consider the need to plan what they would do in the event of the withdrawal of their auditor from the market. It would be for companies to judge whether the risks were such as to warrant taking actions to reduce their impact.
- It could be helpful for directors to advise shareholders whether they have a risk mitigation plan in place and, if so, the nature of any actions taken to mitigate the risk. Such communication could form part of the increased accountability of audit committees described under objective A.2.5 (page 35).

Evaluation of provisional recommendation

- *Effectiveness:* Could lead to more public interest entities taking steps that would help to reduce uncertainty and disruption in the event of their auditor leaving the market.
- *Quality:* Could help to protect audit quality in the event of an incident affecting an audit firm.
- *Cost:* The cost would depend on the actions taken by the company. For example, the company might decide not to use one or more audit firm for non-audit work. In this case the cost would depend on the availability of alternative providers of such work. It is for the companies themselves to judge whether the costs are justified.

Appendix - The Market Participants Group

The Market Participants Group is comprised of individuals from stakeholder groups in the market for the supply of, and demand for, audit services to major public interest entities in the UK. The three principal stakeholder groups are:

- The entities being audited
- The firms providing audit services
- Shareholders and other users of audit services

Members of the Group are:

- Philip Broadley, Finance Director, Prudential plc and Chairman of the Hundred Group of Finance Directors
- Michael Cleary, National Managing Partner, Grant Thornton UK LLP
- John Connolly, Senior Partner and Chief Executive, Deloitte UK, Deloitte & Touche LLP
- David Herbinet, Partner, Mazars LLP
- Huw Jones, M & G Investment Management Limited
- Professor Ian Percy CBE, Deputy Chairman of the Weir Group plc and Ricardo plc
- Michael Power, J P Morgan Cazenove
- David Robertson, Finance Director, Mears Group plc
- Derek Scott, Chairman, Stagecoach Group Pension Scheme trustees
- Robert Talbut, Royal London Asset Management
- Brian Walsh, former Deputy Chairman and Chairman of Audit Committee, Nationwide Building Society
- Peter Wyman CBE, Partner, PricewaterhouseCoopers LLP

The Group Convenor is Paul Boyle, Chief Executive, Financial Reporting Council



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