SUBMISSION TO THE HOUSE OF LORDS ECONOMIC AFFAIRS COMMITTEE:

"AUDITORS: MARKET CONCENTRATION AND THEIR ROLE"

FINANCIAL REPORTING COUNCIL
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AUDITORS: MARKET CONCENTRATION AND THEIR ROLE

1. Introduction and main points

1.1 The Financial Reporting Council (FRC) welcomes the opportunity to give evidence to the Economic Affairs Committee's inquiry into *Auditors: Market concentration and their role*.

1.2 The FRC is the United Kingdom's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC and its operating bodies have a number of responsibilities in relation to audit, including policy, standards, monitoring and investigations. These functions are carried out with the primary goal of improving audit quality.

1.3 The FRC is concerned about the current concentration in the audit market and we have expressed these concerns for some time. Currently, the audit market is not delivering a fully competitive environment, particularly for FTSE 100 and FTSE 250 companies and in sectors such as banking and insurance. Choice and innovation in the market are therefore less extensive than we would wish. We are also concerned about the disruption and cost that would arise in the event of a large firm leaving the market and a subsequent reduction to three or fewer major players.

1.4 We have attempted to address these concerns over the last five years but with no real change in the level of concentration. A new analysis of the impact of the current market structure is now warranted. It needs to take into account the global nature of the audit market and seek the advice of competition authorities here and overseas.

1.5 The FRC works unequivocally to enhance audit quality, which enables investors to make sound judgments, and thereby supports efficient capital markets. We believe that further safeguards should be put in place to enhance audit quality. Specifically, the regulatory framework which determines the relationship between the FRC, audit firms and professional accounting bodies should be strengthened to provide greater transparency, accountability and independence in the public interest.

1.6 We particularly recommend that the FRC should take on certain functions of the professional bodies and should have a wider range of sanctions to address shortcomings in audit quality and for use in disciplinary situations. For example, we believe the FRC should have responsibility for the licensing of auditors of public interest entities – a task that should be undertaken in addition to the general licensing of auditors within the profession itself.
An unambiguously robust and independent regulatory oversight of the audit profession would ensure a speedier response to risks, an increased focus on audit quality and, ultimately, enhanced market confidence in the role and value of audit.

1.7 The Government's decision to abolish the Audit Commission should be used as a catalyst for greater competition in the audit market. The Commission's in-house audit practice is the fifth largest in the UK. Although this work is not in the corporate sector and does not address the international coverage issues, if secured by a non Big Four firm it would enhance their scale and strength and so reinforce their ability to compete. Conversely, if the work goes to the Big Four, the reverse will be true.

2. Current scope of audit and role of auditors

2.1 Audit gives confidence to investors and supports effective capital markets. It provides independent assurance to shareholders that the directors have prepared the financial statements properly and that those statements provide a true and fair view. Additionally, although not its primary purpose, the existence of an audit acts as a deterrent to fraud.

2.2 Given its importance, audit must be done well and investors must have justifiable confidence in its quality. Audit quality is difficult to define and there is no agreed definition of audit quality that can be used as a standard against which actual performance can be assessed. The FRC has sought to address this and to improve understanding of audit quality via its Audit Quality Framework (AQF). The AQF identifies key characteristics and drivers of audit quality to assist companies, audit committees and other stakeholders to assess the effectiveness of audit and auditors.

2.3 Changes that affect the UK audit market should not be made without consideration to the profession's competitive strength and its strategic importance (as part of a successful professional services sector) to the UK economy. Accounting standards are based on international requirements and the largest audit firms are members of international networks and serve many clients with global operations. Any significant regulatory change that would affect the structure of the auditing profession or the role of audit needs to be considered on an international basis.

2.4 The Enron scandal and the subsequent collapse of its auditor, Arthur Andersen, in 2001 led to worldwide concerns about the quality and reliability of audit. In the UK, those concerns were addressed by the introduction of independent monitoring of public interest auditors, oversight and standards-setting to the auditing profession, which had previously been self-regulating. The FRC and its operating bodies were given responsibility for this independent regulation in 2005.

2.5 The auditing profession in the UK has a long history. Most of today's global firms have their origins in UK-based practices. Today, the FRC and the UK profession provide worldwide thought leadership on matters such as auditing standards, ethics and governance[1]. Individuals from the UK are prominent on international regulatory bodies and in the global governance of the largest firms. The UK's thought leadership provides a catalyst for international developments and debate.

2.6 The audit profession's history and importance to capital markets provide evidence of its strengths. The monitoring work of the FRC's Audit Inspection Unit (AIU) also indicates that the audits of most listed companies are performed to an adequate standard. That assessment does not mean, however, that there is no room for improvement. The number of audits requiring significant improvement is too high at around 13% of those inspected. The AIU's report on the 2009/10 round of inspections also noted that four FTSE 350 audits, including two in the FTSE 100, required significant improvement. Appendix B gives a detailed breakdown of AIU inspection findings over the past two years. Whilst the achievement of the highest AIU quality ranking for all audits is probably unachievable at a proportionate cost, we believe that a FTSE 100 audit requiring significant improvement should be a rare and exceptional event. As

[1] The UK is the first major jurisdiction to introduce a governance code for large audit firms, including the appointment of independent non-executives

noted above, we believe that strengthening the FRC's powers to include a broader range of sanctions would both incentivise audit firms to improve the quality of their work and ensure there were more effective tools available to hold the firms to account.

2.7 The AIU's inspections in 2009/10 confirm that major firms have policies and procedures in place to support audit quality. However, the number of audits requiring significant improvement indicates that firms are not always consistently applying their policies and procedures on all aspects of individual audits. In addition, policies and procedures can only go so far in supporting and encouraging desirable behaviours to deliver audit quality. These must be underpinned by other incentives and support for auditors to exhibit the right behaviours and appropriate sanctions when they do not.

2.8 In considering behaviour and culture within the firms, the AIU has identified a number of instances of firms failing to apply sufficient professional scepticism in relation to key audit judgements. This lack of scepticism may manifest itself in a number of ways: over-reliance on management representations; failure to investigate conflicting explanations; failure to obtain appropriate third party confirmations; or seeking to obtain evidence that corroborates, rather than challenges, judgements made by client management.

2.9 Application of appropriate professional scepticism is vital as, unless auditors are prepared to challenge management's assertions, they will not be able to confirm, with confidence, that a company's financial statements give a true and fair view. The AIU therefore looks closely at the evidence of scepticism during its inspections and, if concerned, will seek an improved approach by the firm. The AIU also pays attention to whether recruitment, appraisal and promotion policies reward personnel for delivering high quality audits including displaying appropriate scepticism in their audit work.

2.10 We believe that audit firms and the profession should do more to promote auditor scepticism, for example during recruitment, training and continuing professional development. We have recently published a discussion paper[2] to promote debate on these issues within the profession.

2.11 In addition to our focus on scepticism we also believe it necessary to remain vigilant about the potential for conflicts of interest to arise when an auditor provides non-audit services to their audit clients and for these to undermine audit quality. The primary purpose of audit is to provide assurance to shareholders. However, auditors are in practice selected by a company's management and the appointment only ratified by shareholders, who rarely show interest in the choice. Auditor independence rules exist in part to minimise the risk that auditors become overly influenced by client management, for example in the hope of winning contracts for non-audit work.

2.12 The rules on auditor independence are set through the Auditing Practices Board's (APB) Ethical Standards. The APB has recently consulted on whether auditors should be subject to further restrictions. It has concluded that there is not sufficient evidence to warrant an outright ban on the provision of all non-audit services to audit clients. Indeed all stakeholders, including investors, generally opposed the suggestion. However, the APB has concluded that

[2] 'Auditor scepticism: raising the bar', APB/POB, 2010

some tightening of the standards is justified and has recently published revised provisions for comment.

2.13 Audit quality is not driven by auditors alone. Auditors report on the financial statements which have been prepared under particular accounting standards. Those accounting standards should facilitate the production of an accurate picture of the company's financial health. If they do not, auditors cannot be expected to rectify such deficiencies.

2.14 Corporate behaviour also plays a significant role. Boards are stewards of investors' money and have a responsibility for ensuring that the corporate culture and environment is one which encourages open dialogue with their auditors at all levels. Auditors and individual partners should not fear removal if they challenge management assumptions.

2.15 Audit committees have primary responsibility for the appointment, reappointment and removal of external auditors, and should also review annually the effectiveness of their audit arrangements including the experience, expertise, resources and independence of the audit firm. Audit firms report to us that strong and effective audit committees are a powerful driver of audit quality and that there has been an improvement in the overall effectiveness of audit committees in recent years.

3. Widening the scope of audit

3.1 Despite enhancements in the regulatory environment and in overall audit quality there remains evidence of an expectation gap between the actual scope of an audit and public perception of the information an audit should reveal. This gap was particularly evident in much of the commentary following the financial crisis, with many people querying how a bank could have received an unqualified audit report, only to collapse a few months later.

3.2 In recent months there have been suggestions from various market participants, including some audit firms, that there would be value in widening the scope of audit and in extending reporting requirements beyond shareholders to include bodies such as regulators.

3.3 In June 2010 the FRC and FSA published jointly a discussion paper[3] on the contribution the auditor could make to prudential regulation. The paper suggests a number of recommendations, which are intended to contribute to better supervision of banks and financial institutions.

3.4 The European Commission plans to publish a Green Paper on audit in the autumn and is currently consulting on the role of audit as part of its recent Green Paper on corporate governance. Early feedback suggests that auditors could validate a wider range of risk-related information on financial institutions and engage more closely with supervisory authorities. Although focused on financial services, there is no reason why such an extended audit approach could not be applied across other sectors.

3.5 For its part the FRC has recently launched a project to examine the lessons from the financial crisis and other market developments as they impact on corporate reporting, accounting and auditing of non-financial services companies. To assist with this, the FRC has appointed an advisory group consisting of senior figures from business and the accountancy

[3] 'Enhancing the auditor's contribution to prudential regulation', FRC/FSA, 2010

profession. A discussion document will be published later this year, covering various matters including whether the role of audit should be extended. Our consultation is likely to cover the following topics:

- Greater transparency on the level of assurance provided by the audit;
- Enhanced reporting of the auditor's views on matters arising from the audit, such as values involving significant judgements;
- Assurance on the directors' narrative reports;
- Reporting on risk/company's business model;
- Cost-effectiveness of any changes;
- Safe harbour against liabilities arising from any extra work.

3.6 We will be able to provide further information about this work, including an indication of our early conclusions, in oral evidence to the Committee. We believe it is particularly important to ensure that responsibility and accountability rest in the right place between management, the Board and its audit committee, and the auditor. We would be happy to provide a written update later in the autumn if that would be helpful to the Committee.

4. Market concentration

4.1 The market for the audits of the UK's largest companies is highly concentrated. The "Big Four[4]" audit 99% of the FTSE 100 and 95% of the FTSE 250. Similar levels of concentration are seen in most other developed countries.

4.2 There are a number of reasons for this concentration, which are explored in more detail in Appendix A. However, we believe that market perception is the main barrier to the expansion of non-Big Four firms into the audit market for large public interest entities. Appendix C shows current levels of concentration in the London main market and in AIM. It is notable how few of the smaller fully listed companies use a non-Big Four auditor in comparison to AIM companies. There appears no other obvious explanation for the difference in concentration between these markets. Mid-tier firms may not have the resources to audit the very largest companies, but they are quite capable of auditing a far broader range of companies than is currently the case.

4.3 We believe the economic impact of such a concentrated audit market should be investigated. The investigation should be charged with identifying the causes and effects of market concentration, for example on audit fee levels, as well as identifying catalysts for greater competition.

4.4 Negative features of the current market include:

- The potential for moral hazard as the largest firms consider they are "too big to fail" and judge that governments and regulators will be reluctant to take enforcement action against them if that action had the potential to result in the firm leaving the market. At the FRC we would not moderate our actions to protect a firm from failure but it is of concern that some believe such a risk exists.

[4] The "Big Four" audit firms are Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.

- Lack of choice for large companies, particularly those in certain industries (such as banking and insurance) where only two or three firms are judged to have the appropriate expertise to act as auditor. If the company uses another large firm for other services, such as corporate finance, it may find itself without an effective choice of auditor in the short term due to independence restrictions.
- Lack of innovation in audit, with all large firms offering a virtually identical product[5]. Regulatory restrictions on the scope of audit, independence rules and the format of the audit report offer only a partial explanation for this lack of innovation.
- Little indication that the large firms attempt to distinguish between themselves, or to compete, on quality.

4.6 Our most immediate concern is that the highly concentrated market for audit services, and a litigious market (especially in the US), poses a risk that one of the Big Four could fail. Such a failure may be unrelated to audit; all of the large firms operate other lines of business, some of which, such as corporate finance, are inherently risky and could have significant adverse impact on their reputation with clients and prospective clients. In addition, as the large firms are all members of international networks, the event would not necessarily have to take place in the UK. Whatever the nature and cause of the event, the subsequent collapse of public confidence in the stricken firm could quickly result in an exodus of clients and senior personnel, effectively destroying the business.

4.7 A large firm leaving the market would result in severe disruption to capital markets in the UK and globally, as investors lose confidence in the financial statements of the firm's audit clients. In the longer term, the difficulties around lack of choice and independence conflicts identified above would be exacerbated. Additionally, if the event were audit-related, the remaining firms may become reluctant to audit companies in high risk industries and may even begin to withdraw from certain sectors of the market. At a minimum, a market with three or fewer large firms is likely to require a significantly more intrusive regulatory environment and therefore cost.

4.8 However, we do not believe that the Big Four should be preserved at all costs, and regulators and legislators should not be afraid to take action against a Big Four firm if it is warranted. We would certainly not wish to preserve a firm from commercial failures. We would prefer to see action after failure to prevent the market becoming dominated by just three firms.

4.9 In 2006 the FRC and the then DTI commissioned Oxera to produce a study[6] on the UK audit market. Following the publication of the Oxera study, the FRC consulted on a discussion paper seeking stakeholder views on mitigating risks arising from market concentration. Respondents to the discussion paper had a clear preference for market-based solutions to these risks and to assist in the identification of such solutions the FRC created the Market Participants' Group (MPG) which issued 15 recommendations[7] aimed at reducing risk and increasing choice in the audit market.

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[5] The only recent example we have seen of innovation in the audit product is the "extended audit" service offered to some large companies such as Rentokil plc.
[6] 'Competition and choice in the UK audit market', Oxera. 2006
[7] 'Choice in the UK audit market: final report of the Market Participants' Group', FRC, 2007

4.10 The FRC has been monitoring the implementation of these recommendations and published the most recent Progress Report in June 2010. The majority of the recommendations have been implemented but to date this market-based approach has had minimal impact on market concentration.

4.11 Taking into account the evidence the FRC has received to date, we do not believe that purely market-based solutions have had, or will have, a significant impact on concentration and choice, and that there is a need for regulatory solutions. In June we committed to publishing by the end of 2010 an analysis of the work done so far on the Audit Choice project, together with suggestions for further action. However, given the initiative planned by the Committee we will defer this until we have seen its conclusions.

4.12 Furthermore, in light of the decision to abolish the Audit Commission, the Government should use the opportunity afforded by this change to open up competition to non-Big Four accountancy firms to take on work currently conducted by the Audit Commission.

5. Conclusion

5.1 The FRC welcomes this inquiry and looks forward to playing a part in the solution to the current problems caused by a highly concentrated audit market.

5.2 The FRC believes it has a significant role to play in driving up audit quality and encouraging a more competitive audit market. Currently, the FRC's work shows that audit quality is of an acceptable standard, although a significant minority of audits remains unsatisfactory. With increased powers and a tiered sanctions regime, the FRC could be more effective at holding the profession to account and improving standards.

5.3 Consideration should be given to extending the current scope of audit. However, any changes must be examined carefully to assess their cost-effectiveness and impact on the UK's competitiveness.

5.4 Concentration in the audit market limits choice and poses a substantial risk to capital markets. Market-led solutions have not proved effective and therefore regulatory solutions should now be considered.

5.5 Given the AIU's inspection findings, the FRC is mindful that any efforts to improve choice must not be at the expense of quality.

5.6 The FRC stands ready to work with the Committee to identify and implement practical and workable policies that will improve audit choice and quality for the good of the capital market.

6. Further information

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