Proposed Reform of the External Audit Market

I am writing in my capacity as deputy chairman of the Hundred Group of Finance Directors to share with you the Hundred Group’s views on the proposed European reform of the external audit market and the results of a recent survey undertaken on this topic amongst the Group’s CFO membership. I hope you will find this useful context for your current inquiry into the market for statutory audit services for large companies in the UK.

Who we are

The Hundred Group represents the views of the Finance Directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the FTSE 100, collectively employing over 7% of the UK workforce, and in 2011 paid, or generated, taxes equivalent to 13% of total UK Government’s tax receipts. Our overall aim is to promote the competitiveness of the UK for UK businesses, particularly in the areas of tax, reporting, pensions, regulation, capital markets and corporate governance.

Proposed European reform of the external audit market

As Directors of large public companies, Hundred Group members recognise the value to shareholders of the financial statement audit. The independent auditor’s report is important in ensuring the smooth and efficient operation of capital markets and consequently any action taken to reform this market should be aimed at enhancing, and not diminishing, audit quality.

The case for reform is overstated

However, we strongly believe that the case for reform has been significantly overstated and it is not clear to us, what is the problem the reforms are attempting to address. The vast majority of companies, both in the UK and in the rest of the EU remained strong during the recent financial crisis, and indeed weathered the very difficult economic conditions admirably. Inevitably certain sectors fared less well than others: However to predicate a significant and wide ranging reform on these isolated examples is to ignore the fact that in the vast majority of cases, the role and effectiveness of independent auditors has not been, and should not be, called into question.
Even within the most adversely affected sectors, there is no evidence that particular audit firms performed better or worse than others.

Concentration in the audit market

The biggest concern for many, and in our view the key issue to be addressed, is the further concentration in the audit market that would result from the failure of a ‘Big Four’ audit firm. The proposals do little to address this key systemic risk, nor the lack of global reach of other audit firms which currently result in a Big Four auditor being the favoured option for the multinational organizations represented by our members.

We do not see how the changes envisaged to the appointment regime will increase competition in the audit marketplace and indeed we are concerned that the reforms’ unintended consequences will actually result in concentrating the market even further. The combination of shorter engagement contracts, a cooling off period and prohibitions on non audit work will preclude participation in the audit tendering process of any firm providing non audit services, who are typically for our membership, other Big Four firms. Our members face the real prospect of not being able to recommend to shareholders the appointment of precisely those audit firms best equipped to provide a globally robust audit opinion.

In our opinion the Big Four bias exists because the quality, breadth and experience offered by the Big Four is unmatched by other providers. In order to address this inequality we support and encourage measures that serve to develop other providers, including those which explore the availability of capital to these firms in order to realistically tackle their global presence and technical depth. We hope that the availability of capital will facilitate a period of consolidation amongst smaller audit firms which will result in the formation of a number of new global networks capable of providing a credible alternative to the appointment of a Big Four auditor.

Auditor appointment

We strongly believe that the right to appoint, evaluate and determine the tenure of auditors should be retained by shareholders as the strong and necessary arm of corporate governance. Audit firm rotation risks a real reduction in audit quality in the initial and final years of the appointment. The inevitable reduction in audit quality that would result from mandatory rotation could only be alleviated by increased audit fees during the transition years – a cost which very few investors have expressed a desire to incur.

We do not recognise, and have seen absolutely no recent evidence of (so called) ‘institutional familiarity’. In our view, the regular rotation of audit partners, every 5 years, is sufficient to maintain an independent and robust audit. In our experience, this is complemented by the regular rotation of senior audit staff, which although not mandated, is a common feature of audit engagements in practice.

We support the FRC’s view that audits should be tendered after a set engagement period of at least 10 years, although those companies who did not tender their audit after this period have the option of providing their shareholders a robust explanation as to why they did not.
Non Audit Services

We agree that it is appropriate to prohibit auditors from undertaking certain specific non audit services (e.g. consultancy) where independence could be impaired. However with appropriate safeguards in place, the quality of both the external audit and other specific non audit services can be enhanced if undertaken by the auditor without any impact on independence, and at lower cost.

Audit only firms

We also oppose the creation of specialist audit firms as these will undermine the ability of firms to recruit the appropriate quality of audit staff, with consequent highly negative implications on long term audit quality. A very significant number of UK graduates enter training contracts and qualify as accountants with the big 4 and other professional firms because of the spread of experience they can attain. That has benefits across UK industry in the supply of high quality business executives, many of whom go onto to be Chief Executives in UK plc’s. Audit only firms are highly unlikely to attract such talent, which will then go elsewhere.

Membership survey results

In November 2011, we undertook a survey of our membership to gauge our CFO members’ views on the proposed reform of the audit market. Around two thirds of our current membership responded and I set out the results below.

Do you support proposals for mandatory external audit tendering?

- **Y** (Yes) 14.5%
- **N** (No) 85.5%

Do you support proposals for mandatory external audit rotation?

- **Y** (Yes) 0%
- **N** (No) 100%
Our survey results emphatically show that the case for reform is overstated. In a separate question considering alternatives to the current proposals, respondents thought that the other critical issue to be addressed was not the reform of the audit market, but of regulations governing financial and narrative reporting. The current regime results in audited financial reports which are often too complex, lack meaning and are cluttered with irrelevant, immaterial information which obscures the key financial information being presented. We support the measures the FRC is taking in addressing clutter in financial statements and I would be happy to discuss the results of our survey with you in more detail if you think it would be useful.

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Taken together, the reform package being proposed does not, in our view, address the key systemic risk of further concentration in the audit market and will have the effect, both directly and indirectly, of reducing audit quality (particularly during the period of transition), increasing cost and diminishing the value of the audit opinion to investors, without any compensating tangible benefits.

Please contact me if you would like to discuss the views expressed in this letter.

Yours sincerely

Robin Freestone
Deputy Chairman
The Hundred Group of Finance Directors