

21 February 2012

The Inquiry Manager
Audit Market Investigation
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Our ref: mjs/tp/2102

Dear Sirs

Audit Market Investigation – supply of statutory audit services to large companies in the UK

We are writing in response to the Issues Statement which was published as part of your enquiry into the supply of audit services to large companies in the UK, namely those in the FTSE 350. Kingston Smith is a member of the 'Group A' firms and the Association of Practising Accountants (APA), although we would note that this letter represents our views and not those of either Group A or the APA.

We apologise for the delay in submitting this response, however we would make the following observations:

- the request for comments on the Issues Statement (as opposed to the commencement of the enquiry itself) does not appear to have been particularly well publicised to the profession as a whole;
- there appears to have been relatively little comment to date from the mid tier of the profession, and we believe that there is a clear need for such comment;
- it appears that there has been little in the way of request by the Commission for evidence from the mid tier, other than from the largest firms outside the Big Four. Surely it is not possible to enquire into the competitiveness or otherwise of a market without making an effort to discuss that market with a reasonable sample of those firms that may be interested in participating in it, but which do not at present do so to a significant extent.

In respect of the last point, we would note that relatively few firms outside the Big Four have made formal presentations to the Commission; at the date of writing Grant Thornton, BDO and Mazars. Whilst we note that the ICAEW have made a presentation, we would urge that the Commission specifically approach other firms outside the Big Four to state their case, including the Group A firms and the Association of Practising Accountants.

Whilst not all such firms may necessarily wish to be involved in the audits of the largest listed companies – for a variety of reasons some of which we have explored in this letter – some,

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particularly the larger Group A firms, undoubtedly would welcome the opportunity and others may wish to be involved with such companies in other ways, for instance through the mechanism of shared audit which we have discussed in more detail below. We also believe that it would be beneficial to the Commission's enquiry to hear directly from other firms about the barriers to entry to this market; we are aware that various points have been raised by Grant Thornton and BDO in their responses to the Issues Statement, and by Mazars in their presentation to you, but these firms represent only three of the many non Big Four firms and we believe it is vital that the Commission obtain its evidence from a wide variety of sources outside the Big Four in order to obtain a balanced view of the issues.

We have considered and commented below on the various points raised in the Issues Statement. Where we have not commented specifically, this should not be taken as agreement with the comments in the Statement.

Background and characteristics of the market

Without doubt, concentration at the top end of the audit market is a 'hot topic'. The aftermath of the financial crisis – and the misperception that the audit profession must in some way have been at fault – has led to a series of consultations on various topics, including the FRC consultation on the provision of non-audit services, the House of Lords enquiry, and (probably most importantly) the EU Green Paper on audit and the subsequent proposals which would, if enacted, drastically change the audit market for listed companies without, in our view, necessarily promoting competition in any way.

Clearly the period of consolidation in the audit profession in recent years has exacerbated the concentration in the market. The reduction of the Big Eight to a Big Five, followed by the subsequent collapse of Arthur Andersen, has resulted in the larger end of the audit market being limited almost exclusively to four firms. Indeed, as observed in the Statement and in various responses to it, in some sectors, most notably banking, only three firms are operational. Whilst we do not doubt that competition between the Big Four firms exists for the audits of larger companies, we do not believe that the current situation is healthy (either for audit firms or for businesses), and we do believe that it needs to be addressed. There are a number of firms outside the Big Four which have the capability, resources and willingness to undertake large listed audits, but simply are not being given the opportunity to do so, either as a result of restrictive practices (e.g. Big Four only clauses) or as a result of misperceptions about audit quality, international coverage, or expertise.

We believe that there are a number of measures that could be taken to increase competition without the need for draconian measures such as those proposed by the EU (e.g. banning the provision of non-audit services by the auditor). These include:

- a ban on 'Big Four Only' clauses or indeed size restriction clauses of any kind;
- periodic mandatory tendering on a 'comply or explain' basis with the participation of at least one non Big Four firm;
- the introduction of a workable limitation of liability mechanism, proportionate to the degree of fault; and
- the introduction of compulsory shared audit, where a non Big Four firm audits a certain percentage of the subsidiaries of a large listed group, thereby gaining experience of the market.

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We have commented on these points further below where appropriate.

Possible adverse outcomes

We have various points to note on the possible adverse outcomes of market concentration set out in the Statement.

Suboptimal audit quality and levels of innovation

We do not believe that there is any particular evidence of a lack of audit quality arising from concentration at the top end of the audit market, or of 'gold-plating' of requirements. Larger firms invest a great deal of time and effort in their audit processes and procedures; it is also worth noting that AIU reports stress the need for continual improvement rather than suggesting in any way that over-auditing occurs.

However, we do not believe there is any evidence whatsoever that the quality of a Big Four audit is automatically better than that of an audit performed by another firm. Indeed, high profile audit failures have affected Big Four firms in recent times as well as other firms. The reports produced by the AIU show evidence both of high quality audit outside the Big Four, and of quality issues occurring at the Big Four, as well as vice versa. What we do believe exists is a misperception by businesses and investors that a Big Four audit is automatically 'better' because of their sheer size, and that a Big Four auditor is therefore a 'safe pair of hands'. As noted above, this reduces the opportunities available for other firms to gain access to the market and these misperceptions therefore need to be addressed.

Higher prices and costs

Whilst increased competition may lead to a reduction in fees, it does not necessarily follow that fees are currently at an artificially high level. Fees charged will inevitably depend on a number of factors of which competition is only one. However, in some cases we are aware that an unrealistically low fee may be charged by an incumbent auditor in order to retain the client, subsidised from their considerable other income and therefore precluding change; [Redacted] Similarly, we have heard of examples of the large firms charging low fees in order to obtain audit work for growing companies. In effect if a Big Four firm wishes to obtain or retain or win an audit client it is very likely to substantially reduce the audit fee in order to do so. It is simply not possible for smaller firms, which do not have the same level of income as the Big Four, to price their services aggressively in the same way and this clearly has an effect on competition; for instance, we are aware that BDO have referred to the use of deep discounts by the Big Four in their presentation to you.

Less competition in non-auditing markets

In recent years, it has become more common for companies to look to a firm other than their auditor for non-audit services; indeed in some cases this is now obligatory because of restrictions in the Ethical Standards for Auditors. We would however tend to agree with the Commission that the auditor generally has an advantage in winning non-audit work (that they are permitted to perform under the Ethical Standards) because of their existing knowledge of the client.

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Nonetheless, we do not believe that further restrictions over the provision of non-audit services – as proposed by the EU – are necessary. The provision of non-audit services results in increased, rather than decreased, audit quality as a result of the breadth of knowledge obtained by the audit firm, and the system of checks and balances already present in the Ethical Standards is an effective framework for managing potential or perceived conflicts of interest. We do not believe that a ban on the provision of non-audit services by the auditor would increase competition as it would be possible for a company simply to look to another Big Four firm.

Theories of harm

Concentration and barriers to entry

As noted above, we do believe that there are significant barriers to entry and we note that Grant Thornton and BDO have commented on these in some detail. We agree with these firms, and have commented above, that there is a misperception that a bigger audit firm equates to a better quality audit where there is no evidence that this is the case. Indeed, in the context of these perception issues, the other potential barriers to entry discussed in the Statement – for instance costs of firms raising capital, or of increasing levels of staff in order to compete – become something of a ‘red herring’. Firms are highly unlikely to want to increase resources ‘on spec’ if they believe there is no realistic prospect of obtaining the additional work in any event due to misperceptions.

We note the comment in the Statement that there may be a further misperception that appointing a non big four auditor is somehow damaging to a company’s reputation and that there is a trend for replacing a non-big four auditor with a big Four auditor when a company enters the FTSE 350. We would suggest that the Commission examine this trend and the reasons for it carefully when making their enquiries. We would stress that the fact that the Big Four comment on the quality of audit they can provide (which we do not disagree with) does not mean that other firms are not capable of providing an equally good quality of service.

We do not believe it is the case that only the Big Four possess the capacity to audit multi-national groups. Indeed many of the larger firms in the UK outside the Big Four are members either of international networks or international associations of independent firms and therefore possess the capacity to service such groups and provide the necessary international and local expertise and ‘joined up thinking’. The idea that only the Big Four have sufficient international presence is simply another misperception which needs to be addressed.

Another barrier to entry which we believe needs to be addressed urgently for any meaningful change to result is the lack of a workable limitation of liability mechanism, the current system being unenforceable; clients can and do simply refuse to sign limitation of liability agreements. This means that firms may be reluctant to take on larger – and therefore higher risk – audits because of the risk of being perceived as having the ‘deepest pockets’ in the event of a claim arising, even if they possess the knowledge and expertise to offer such clients an excellent quality of service. The introduction of a robust liability limitation mechanism, proportionate to the degree of fault, would reduce the risks of entering this market and therefore make it more attractive to a wider range of firms; indeed, we do not believe that any significant increase in competition at the top end of the audit market is possible without such a mechanism being put in place.

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Bundling of services

As noted above, we do not believe in the imposition of any more restrictions on the ability of auditors to provide non-audit services. Addressing perception issues would have an effect both on the provision of audit services and of non-audit services.

However, we do believe that there are issues in respect of multinational (or indeed large national) firms and the 'bundling' of subsidiary audits with that of the parent. We believe that ISA 600, which deals with the audits of groups of companies, is being misinterpreted as requiring the same auditor across either the whole group or the vast majority of the group. This is not what the Standard actually requires and we strongly believe that the introduction of enforced shared audit – where a firm outside the Big Four audits a certain percentage of the subsidiaries of a multinational group – would be highly beneficial to increasing competition without the attendant issues that may arise with joint audits (e.g. who is responsible for auditing what).

As an example, a mid tier firm could audit 20% of the trading subsidiaries of a large listed group that require a statutory audit opinion. The remaining 80% would be audited by the parent company auditor. This level of involvement in the group audit would not pose any problems for the parent company auditor in complying with ISA 600 as it would still be auditing the vast majority of the group; it would also be quite clear where reporting responsibilities lay as the subsidiary auditor would take responsibility for expressing the statutory audit opinion as well as reporting to the parent auditor, who would take sole responsibility for expressing the opinion on the group accounts. As a result of this involvement, the mid tier firm would be able to build the 'track record' in dealing with larger groups to prevent misperceptions at future tender opportunities, ultimately enabling it to challenge for the audit of similar groups. As well as increasing competition; shared audit would also enable firms outside the Big Four to grow their capacities (and therefore ultimately obtain the necessary headcount to take on larger audits) without the need to do so 'on spec' as discussed above.

We would note that in this context we believe that the proposed deregulation of the audit of UK subsidiaries by BIS is extremely damaging as if a subsidiary audit is only required for group reporting purposes it will be far less likely that the parent company will consider using other firms .

We would further stress, as noted above, that firms other than the Big Four possess large multinational networks and it is therefore unhelpful for the Statement to note that bundling of subsidiary audit for multinational companies 'could hinder the ability of mid-tier firms to access the statutory audit market for large companies in the UK'.

Customer conduct/ infrequent tendering

Whilst we would agree that there are costs for companies of switching auditor, we believe that the level of tendering among larger listed companies is far too low and as noted earlier in this letter we believe that there is therefore a case for mandatory re-tendering, involving at least one non Big Four participant, on a 'comply or explain' basis. The use of 'comply or explain' would allow for special circumstances such as in respect of the audit of banks where the necessary specialist sector knowledge does not at present exist outside the Big Four.

Mandatory re-tendering would allow firms outside the Big Four to demonstrate their expertise – including where relevant their international capabilities – without the need for the draconian

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sanction of mandatory rotation (which would not in any case automatically lead to increased competition, as it would be possible for audits simply to be rotated between Big Four firms). We do not believe that mandatory tendering should be extended outside the FTSE 350, however, as below this level increased competition already exists and enforced re-tendering could therefore risk being counter-productive to competition.

Risks of regulatory failure

We do not believe that the regulatory framework in the UK is particularly geared to be favourable or unfavourable towards firms of particular sizes, although sometimes the tone of public comment by the AIU about smaller firms has tended to suggest they have doubts about the ability of such firms to take on larger audit work, which is extremely unhelpful in the context of promoting increased competition. We do believe there is a case for ensuring that non Big Four firms are represented on regulatory bodies, for instance the FRC and its various subcommittees. This might in itself help to temper the tone of the reports produced by such bodies.

We believe that the level of regulation needs to be proportionate and agree that over-regulation can and may act as a barrier to entry – for instance the prospect of having to comply with the Audit Firm Governance Code may be off putting to some firms, as may be the prospect of being subject to regulation by the AIU, as the costs of compliance may outweigh the benefits of access to larger audit markets. (We would stress that we are not advocating that AIU reviews are unnecessary as we accept that reviews are required in order to monitor competence – however we do believe that they need to be proportionate, for instance focusing only on the audits of those companies with the greatest level of systemic risk).

Tacit coordination resulting in reduced competition

We are not aware of any particular evidence of tacit coordination resulting in reduced competition, although we accept that this does not mean that it does not exist. As noted earlier in our response we do believe that competition exists at the top end of the audit market – the issue is that such competition is restricted to the largest firms and that the ability of other firms to compete in that market needs to be addressed.

Information asymmetries and conflicts of interest

We agree that investor perception – particularly that of institutional investors - may be another reason why large companies are reluctant to entertain the idea of using a non big Four auditor, particularly if there is a belief this may lead to a lack of investor confidence. Again, mandatory re-tendering might help to address this issue.

In terms of managing information gaps between auditors, the directors of a company and its investors we believe that the audit committee has a vital role to play. Increased communication by the auditor to the audit committee, and by the audit committee to investors, is in our view a far better way of addressing misperceptions about auditor independence, or what an auditor actually does, than draconian sanctions such as further restrictions on non-audit services or the vastly expanded audit report proposed by the EU.

We do not believe that a long working relationship between an audit firm and a company leads to the directors being able to influence the audit or compromise its independence – this is addressed

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by the requirement in the Ethical Standards for rotation of the audit partner on a listed audit after five years.

Failure of a Big Four firm

We would agree that in the event of a failure of one of the existing Big Four firms, the issue of concentration at the higher end of the market would be further exacerbated, particularly if the firm in question was one of the three that currently audit systemic financial institutions. However, it is impossible to predict whether such an event is likely to happen, and we do not believe that any firm, even one of the Big Four, should be regarded as 'too big to fail' and therefore needing any sort of special protection. We would, however, note that in the case of the failure of Arthur Andersen, the majority of the UK firm was absorbed by another Big Four firm (Deloitte) which further exacerbated the lack of competition; in the event of a similar failure in the future, we would suggest that the failed firm, or sections of it, be strongly encouraged to join forces with a mid tier firm or firms rather than simply merge into one of the other larger firms.

We hope that this letter is helpful and would reiterate that the Commission needs to take the views of potential as well as actual participants in the FTSE 350 audit market into account when obtaining evidence and considering its actions. If you have any questions on the contents of this letter, then please contact either Sir Michael Snyder or Tessa Park.

Yours faithfully



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