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Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
London
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Dear Sirs

Statutory Audit Services Market Investigation - notice of a further possible remedy

Following on from our initial response to the potential remedies proposed by the Commission to address the lack of competition in the audit market for larger listed entities, we are pleased to respond to your recently published request for comment on a further possible remedy; specifically the proposal that the Financial Reporting Council ('FRC') be given a secondary duty to promote competition between audit firms.

Our overall view on this proposal is that it is an interesting idea, but one which would be challenging to make effective in practice. We have set out our reasons for holding this view in more detail below.

Would giving the FRC a secondary duty to promote competition between auditors be effective, given how the Commission propose this should be done?

We note that paragraph 7 of the Notice states that 'the FRC would be required to carry out its primary duties in a way which, so far as possible, promoted competition between firms providing audit services to FTSE 250 companies'. We assume that the reference in this paragraph to 'FTSE 250' companies is a typographical error as elsewhere in the Notice the reference is to FTSE 350 companies (i.e. the reference market) and that paragraph 7 is not meant to imply that there would be a duty to promote competition within the FTSE 250 but not the FTSE 100. Clarification in this respect would be helpful. Also, the use of the phrase 'so far as possible' could be read to imply that there may be some companies for which promoting competition is simply not possible, but we would argue that this is limited to systemic financial institutions and certain other very large, or very specialised, businesses.

We also note that the principal mechanism that it is proposed the FRC could implement is increasing the transparency of Audit Quality Review (AQR) reports. It is suggested that this would enable companies and shareholders to better assess the quality of their existing auditor and that it would make companies more likely to switch, and also increase their bargaining power. Whilst we

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note that the FRC has made some moves in recent years to promote increased competition, for instance by introducing a ten year tendering cycle on a 'comply or explain' basis, we have some doubts as to whether this proposed mechanism would be effective and indeed it could have some unintended side effects.

The composition of the FRC

One potential issue with requiring the FRC to take on this secondary duty is that our understanding is that the majority of serving members of the FRC and its various subsidiary bodies – including the AQR –that are drawn from the profession, are drawn from Big Four backgrounds. Therefore, such individuals do not have any direct experience of the high quality of service that can be provided by mid tier audit firms and there is therefore a risk that the 'alumni effect' may apply to some extent at the FRC. Indeed, the FRC (particularly the AQR, in its previous incarnation as the Audit Inspection Unit) has historically been quite critical of 'smaller firms', and this has been unhelpful in terms of promoting wider competition.

However, we acknowledge that the FRC has now taken some steps to address this, including no longer publishing a separate report on 'smaller firms'. It was also helpful to note that, if anything, it was the larger firms that came in for most criticism in the latest AQR annual report which was published recently. As we have noted all along, examples of both high quality and poor quality auditing can be found in firms of all sizes. We would however recommend that if this additional duty is to be taken on by the FRC that the serving members of the FRC and its various bodies need to be drawn not just from the largest firms but also from the mid tier so that the FRC, in undertaking its duty to promote competition, has a wider direct experience of the mid tier firms and the quality of their service than is currently the case.

Increasing the transparency of AQR reports

There are certain practical aspects of this proposal which would need to be considered carefully to ensure that such a measure was not counter productive.

Firstly, as noted above, the AQR is, to the best of our knowledge, drawn largely from individuals with large firm backgrounds. Whilst there may be practical reasons for this to some extent (for instance where specialist expertise is required to review the audit file for a systemic financial institution) a Big Four background is not required to review all audits of listed companies or for that matter all audits of companies in the reference market. To recruit individuals with mid tier backgrounds and relevant experience would help to address any potential 'alumni effect' at the AQR.

We are also concerned that in any 'increased transparency' regime there could be a tendency for companies and investors to place more weight on any findings of audits requiring significant improvement at mid tier firms than at Big Four firms; the misperceptions that certain companies and investors have about quality at both types of firm (on which we have commented previously) could lead to such instances at mid tier firms being viewed as evidence of systemic issues but similar instances at Big Four firms being viewed as isolated 'hiccups'.

Another issue is the timing and frequency of AQR reports. Currently, only the Big Four are reported on annually, with five other firms being subject to cyclical visits at least once every three years. This means that it is not possible for a company to compare the quality of a Big Four auditor with one of the other five audit firms for a particular year if the other firm had not been reported on during that year. Historical reports, which may be out of date, would need to be referred to.

In addition, there are many other firms that have been subject to AQR monitoring only in respect of certain individual audits, such as listed and large AIM companies. Going forward, such reviews will not be conducted by the AQR, but rather will be undertaken by the relevant monitoring bodies, under AQR guidance. The results of such reviews will therefore presumably not be in the public domain, or if they are, will only be in the public domain in the form of summarised information in the AQR's annual report.

As a result, any increased transparency – or increased opportunity resulting from it - would only apply to the nine firms subject to either annual or cyclical AQR reporting. Those firms falling outside the scope of such reporting would not benefit. However, extending the scope and frequency of AQR reporting would in our view place a disproportionate burden on mid tier firms; it may be that some of the largest mid tier firms would be prepared to accept more frequent reporting if they believed that they would receive increased opportunities as a result, but most mid tier firms would find any increased reporting to be extremely onerous.

Issues of client confidentiality would also need to be considered in any regime of increased transparency. If a report referred to a FTSE 100 client audited by a mid tier firm, and it was common knowledge that the firm audited only one such company, then the identity of the company in question would be obvious and details of its audit would then be in the public domain that it might prefer to be kept confidential. Of course, this will be less of an issue if the Commission introduce measures which are genuinely successful in increasing the number of clients in the reference market audited by firms outside the Big Four.

Would giving the FRC such a duty assist companies in comparing auditors?

In theory, increased transparency could assist companies in comparing auditors. However, as noted above, annual comparisons would only be possible between the four largest firms and would only be possible at all between nine firms, so increased competition would not automatically result. We would also note that companies are unlikely to make a decision on choice of auditor purely on the basis of the results of an AQR inspection.

The tone of any expanded or more transparent reporting would also need to be considered carefully so that they can be read in a constructive, rather than necessarily a critical, light. Indeed, the AQR acknowledge that 'as the focus of our reporting is on those aspects where improvement is required, our reporting may create the impression that there may be more problems with the quality of auditing in the UK than elsewhere.' We also note the comment in paragraph 1.3 of the AQR public report on KPMG and KPMG Audit Plc that 'this report is not intended to provide a 'balanced scorecard' because of its focus on matters where it believes improvements are required. More transparent reporting would need to be balanced, fair and reasonable – focusing on areas of good quality as well as areas that require improvement - in order to provide companies with a fair comparison between firms.

We would also note that part of the reason that many AQR reviews identify the need for some improvements is that the reviews are extremely detailed, and for smaller listed companies the review may take almost as long as the audit took to do. Since it is extremely difficult to perform a perfect audit, some potential improvements will almost always be identified. Improvements, in this context, may also relate to documentation rather than procedures and even when an audit is identified as requiring 'significant improvement' this does not necessarily mean that the audit opinion was incorrect. As the latest annual report itself states, 'A poor overall assessment of the audit therefore does not necessarily imply that the financial statements were materially inaccurate or incomplete, or that an inappropriate audit opinion was issued.'

Would giving the FRC such a duty assist shareholders to influence the audit appointment?

Again, in theory it might, but this will depend on the willingness of shareholders to make their views known to the audit committee when the audit committee are considering the audit appointment, and also to take action (for instance by voting against the recommendation of the audit committee at the Annual General Meeting). We would also stress that in order for genuine competition to result, the misperception that is held by some (although we acknowledge not all) institutional investors that 'only a Big Four firm will do' need to be addressed.

The points we have made above in respect of more transparent AQR reporting are also relevant when considering how shareholders might view such reporting.

We hope that these comments are useful to you. In addition, we would urge the Commission, when making a final assessment of the remedies it intends to introduce, to consider:

a) Requiring the inclusion in invitations to tender of at least one firm outside the Big Four, on a 'comply or explain' basis;

b) Introducing mandatory shared audit, which we have discussed at length in previous submissions; and

c) Requiring the introduction of a workable mechanism for auditors to limit their liability, proportionate to the degree of fault.

If you have any questions on the contents of this letter, then please contact either Sir Michael Snyder or Tessa Park.

Yours faithfully

Kingston Smith LLP