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

Provisional findings of the Competition Commission in respect of the FTSE 350 audit market and possible remedies to the adverse effect on competition

Following the recent publication of your provisional findings into the market for larger listed audits in the United Kingdom, we are responding to your request for comments. We have commented below on the various consultation questions raised in the Notice of Possible Remedies, but also have some overall comments (and concerns) about some of the conclusions which the Commission has drawn.

We were pleased to note that the Commission has identified that there are features of this market which act to distort competition. One of the most significant of these is the reputational barrier that mid tier firms face when attempting to gain a foothold in this market – which was borne out in the case studies and the previous working paper on the views of investors on which we provided separate comment. We would also agree that companies face significant hurdles in comparing the offerings of an incumbent auditor with a potential new auditor; we were also pleased to note that the Commission has not proposed any increase in restrictions on the provision of non-audit services by the auditor and has proposed to ban 'Big Four Only' clauses in template documents, although how verbal 'encouragement' to do the same thing (which is equally real) will be prevented has not been addressed.

However, we do not believe that the remedies proposed by the Commission will address the issue and indeed some of the proposals risk making the situation worse rather than better. We are extremely disappointed that the option of shared audit appears to have been entirely dismissed, particularly given that shared audit would enable firms to establish a track record in the market, the perceived absence of which is a key issue for potential customers which has been identified in the report and which we believe will be extremely difficult or even impossible to establish without some form of shared audit being introduced. In fact it is the only proposal that would actually work in practice.

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We also do not agree that auditors are insufficiently independent from executive management and are insufficiently sceptical – professional scepticism is the bedrock of performing a robust audit and we do not believe that there is any significant evidence that auditors are failing to apply professional standards in this area. A relationship of trust and confidence with an audited entity does not equate to a loss of independence, or scepticism, on the part of the auditor provided appropriate professional and ethical standards are being applied.

We have commented on the specific points on which representations are sought in respect of remedies in turn below. Where we have not commented on a specific point, this should not be taken as agreement with the Commission's proposals.

1. Mandatory tendering of the audit appointment

We have previously expressed the view that we would support mandatory tendering, with firms outside the Big Four being mandated to be included, on a 'comply or explain' basis. We believe that the introduction of mandatory tendering – *if and only if the involvement of firms outside the Big Four was mandated* – would allow mid tier firms a greater opportunity to demonstrate their competence and abilities to potential customers in the reference market. Our reason for suggesting that this should be on a 'comply or explain' basis (although the expectation should be that companies would comply, rather than explain) would be to allow for exceptions to be made in the case of some very specialised entities, for instance systemic financial institutions, where the expertise to audit such entities is not currently available outside the Big Four. As we have commented previously, the fact that mid tier firms have admitted that there are some entities within the reference market that they would not be able to audit should not be taken to indicate any wider sort of inability to audit other entities within that market.

However, the proposal made by the Commission differs from our suggestion in a crucial respect; there is no suggestion whatsoever in the Commission's recommendations of mandating involvement by firms outside the Big Four. Given the views of some (although we accept not all) investors and companies, previously expressed in working papers published by the Commission, that 'only a Big Four firm will do' in our view this will mean that, in the majority of cases, companies in the reference market will simply continue to ask only Big Four firms to tender. This is often the case at present, as is borne out by the recent comments to the Commission from BDO. Misperceptions about mid tier firms will not therefore be addressed in any way and whilst the proposal might increase competition for audits *within* the Big Four (which arguably already exists) it will not broaden competition to include firms *outside* the Big Four in any meaningful way.

In order to promote competition all participants in the tender process would need to have a level playing field – one firm should not be favoured at the expense of another. We can see the benefit of allowing an 'open book' tendering process in which tendering firms would be permitted to review the audit files of the incumbent although this would clearly require regulatory changes and we are not convinced it would reduce costs significantly.

The time frame for tendering should, in our view, be linked to the period for rotation of the audit engagement partner as this provides a natural 'break point'. We would propose mandatory tendering every ten years – two partner rotation cycles – as we believe that tendering every five years would be unduly costly for companies in the reference market (and potentially for audit firms as the cost of participating in a tender for a large company can be very significant). This is in line with the time frame in the FRC's revised Corporate Governance Code. A staggered approach to transition, with companies with the longest period since the previous tender being required to tender first, would appear to be appropriate; a situation where too many companies in the reference market are tendering at once should certainly be avoided as potentially disruptive.

2. Mandatory rotation of the audit firm

We do not agree that mandatory rotation would in any way reduce the barriers to involvement of non Big Four audit firms in the reference market. In our view, and due in large part to misperceptions of companies in the reference market (for instance the approximately ¾ of finance directors and audit committee chairs who, according to the results of the Commission's survey, would only consider a Big Four auditor) and their institutional investors, the imposition of these proposed remedies would simply mean that, as noted above, tenders would often be restricted to Big Four firms (unless non Big Four involvement was mandated) and that therefore the audit itself would simply rotate around the Big Four. There would therefore be no improvements at all in the form of reduced costs for businesses.

Indeed, we believe that mandatory rotation would actually be counter-productive and would damage, rather than increase, the chances of wider competition. Given the views of some institutional investors that large listed companies should usually switch *to*, rather than *from*, Big Four firms – and that in practice this is the direction in which the majority of switches occur – the requirement to rotate auditor increases the risk of mid tier firms losing their existing clients in the reference market with no guarantee that they will gain other clients from the Big Four to compensate, particularly given misperceptions and the views of some (if not all) investors that such a switch would constitute 'opinion shopping'. In any event the Big Four can afford to price their fees to eliminate a non Big Four firm at any time they wish to do so. Mid tier firms are unlikely to even wish to compete on a regular basis for audits in the reference market if they believe that they are unlikely to have any realistic chance of winning, as the costs of bidding are considerable.

We cannot see that it would be possible to force a company in the reference market to choose a non Big Four auditor when their shareholders or management do not wish to do so without direct regulatory intervention in the choice of auditor, with which we do not agree (and have commented on further in response to question 8). The proposals, as drafted, therefore offer no benefit to the mid tier and will serve only to increase costs for businesses with no tangible benefits as a result. We also do not believe that this measure is required to improve auditor independence as this is already addressed by the partner rotation requirements in the Ethical Standards.

In the event rotation is introduced then linkage of the time frame to (a) the tendering process and (b) audit partner rotation would make sense. As noted above we have suggested that mandatory tendering should take place every ten years. Whilst we do not agree with mandatory rotation at all – as should be clear – a 'long stop' rotation period of two tender cycles or twenty years would at least mitigate to some extent the costs for businesses and loss of continuity and knowledge that would result from a shorter rotation period.

3. Expanded remit and/or frequency of AQRT reporting

Whilst we have no particular objection to the publishing of the results of reviews of FTSE 350 entities separately from other listed entities (and indeed have noted in previous correspondence that the scope of such reviews should focus on the companies with the greatest systemic risk) we do not see that this will assist competition. The AQR already report specifically on the largest firms and we do not see any particular advantage in reporting on individual audit engagements rather than the firm overall. Indeed reporting separately might give a misplaced view of poor quality at a particular firm as readers of such reports might focus overly on reviews of individual audits which required significant improvement rather than those that were satisfactory.

Given the small number of FTSE 350 audits performed by non Big Four firms, and the widespread misperceptions about lack of quality outside the Big Four, we also believe that any findings of poor quality in respect of such audits would be given undue weight by investors and companies compared to similar findings at Big Four firms. In the past the tone of public comment by the AIU about 'smaller firms' has also tended to suggest that they have doubts about the ability of such firms to take on larger audit work, which has been unhelpful in the context of promoting increased competition.

We also believe that any such expansion of the work of the AQR would be unduly onerous and time consuming, as well as costly, not only for the audit firms subject to review but for the Financial Reporting Council. Whilst we can see that some stakeholders, for instance the institutional investor community, might welcome the increased transparency we do not believe that this possible benefit outweighs the associated costs and risks.

4. Prohibition of contractual clauses in template documents limiting choice to the Big Four firms

We welcome this recommendation by the Commission and are entirely in agreement that 'Big Four Only' clauses, or indeed any size restriction clauses, should be prohibited. This prohibition should not be limited to lending documents but extend to any document in which such a prohibition might reasonably be included, for instance company governing documents. The costs of this should be minimal and the benefits – removing an artificial restriction on the ability of businesses to choose their professional advisers – are evident. It does not, however, remove the real risk of any verbal 'encouragement' to ensure a Big Four appointment, the risk of which is significant (and would remain so even if written size restriction clauses are banned).

5. Strengthening accountability of the external auditor to the Audit Committee

We do not agree that audit firms 'bypass the Audit Committee Chair' in performing their roles or that audit partners are necessarily too close to the finance director. The proposal that the reporting lines between the audit partner and the audit committee chair should be strengthened and those with the finance director diminished are potentially attractive on the basis of recognising the role of the audit committee in representing the interests of shareholders, but we are concerned that expansion of the role of the audit committee chair – particularly in terms of being the first port of call to discuss material audit issues - could add significantly to costs for businesses. The role of ACC might also become less attractive to those individuals that take such roles as a result because of the increased time commitment involved.

We would note that a good relationship between the audit firm (particularly the audit engagement partner) and the finance director is important to ensure the audit runs smoothly but the existence of such a relationship does not impair audit independence so long as appropriate professional standards are followed.

Having said that, requiring the ACC to take principal responsibility for negotiating audit fees, initiating tenders, dealing with relationship issues with the auditor and agreeing non-audit assignments would in our view be a better solution in terms of addressing misperceptions of independence issues than the draconian sanction of mandatory rotation. We do not, however, believe that it would have any significant effect on improving competition because of the 'alumni effect' which extends not only to finance directors of companies in the reference market but also to individuals with the appropriate expertise to take on such a role as the expanded ACC role proposed.

6. Enhanced shareholder/ auditor engagement

In our view, the best route to enhanced shareholder/ auditor engagement is by increased communication and dialogue with the audit committee, which we believe is achievable without the need to overly restrict the auditor's relationship with the finance director. We do not believe there is any particular value in such measures as requiring the auditor to present at, or answer questions at, the Annual General Meeting and indeed such measures risk audits in the reference market being seen as less attractive by potential entrants because of the additional risks involved. Moreover they would only enhance the influence of the institutional investor community at the expense of other shareholders or indeed other stakeholders. An effective audit committee looks after the interests of *all* shareholders and as such other measures should be unnecessary.

We do not believe there should be any requirement to increase the majority required to reappoint the auditor if the incumbent is retained following a tender. This appears to presuppose that there is something wrong with retaining the incumbent when they may well simply still be the best firm for the job. We also do not believe that shareholders should be able to force a tender – it should be down to the company to determine whether a tender is appropriate outside any normal tendering cycle as the company will be in the best position to assess the issues which would lead to such a tender being necessary.

7. Extended reporting requirements

We would note that this is the subject of current consultations by the Financial Reporting Council and that therefore the Commission should consider their final recommendations in this area through dialogue with the FRC, taking into account the responses to the consultations (which are currently open and will be for some weeks). Generally, we are not in favour of any expansion to the audit report – for instance to disclose materiality and key audit risks as proposed by the FRC – as we believe that this increases the risk to the auditor to a level which is unacceptable and is also likely to be counter-productive to competition as a result. The solution in our view is enhanced communication between shareholders and the audit committee with the audit report continuing to serve the purpose it was designed for, being the expression of an opinion on the truth and fairness of the financial statements.

We note with concern the suggestion that the auditor should comment as to whether the company's interpretation of accounting standards 'complies with the norm'. We would stress that a company's accounting policy in a particular area could be different from the 'norm' for a particular industry but still be perfectly acceptable, because of the particular circumstances of the business. There is simply no need for an additional requirement to comment on whether accounting policies comply with International Financial Reporting Standards as this is implicit in expressing an opinion on the truth and fairness of the financial statements; where the auditor does not believe that the company has complied with IFRS, and the effect on the financial statements is material, the auditor will then qualify their report on grounds of disagreement.

8. Remedies that the Commission is not minded to consider further

We are pleased to note that the Commission is not considering any further restrictions on the provision of non-audit services by the auditor. An effective and established system of checks and balances on the provision of such services already exists in the form of the Ethical Standards for Auditors and is, in our view, working well in dealing with actual, potential or perceived conflicts of interest or independence issues.

We are also pleased to note that requiring the FRC to appoint auditors for companies in the reference market is not being considered. We would agree that lack of familiarity with the companies concerned and their business models could lead to ineffective appointments and we would also be concerned that the FRC (or for that matter any other regulator that was tasked with determining such appointments) would default to using the Big Four as a 'known quantity' in the reference market. Similar problems in terms of lack of detailed knowledge of the business and the 'IBM effect' could arise if auditor appointments were determined by a shareholder panel. It is the companies themselves (including their audit committees) that are in the best position to determine a suitable auditor and make an appropriate recommendation to shareholders.

We are, however, as noted in our opening remarks, extremely disappointed that the Commission does not propose to consider the option of mandatory shared, or component, audit. We believe that mandatory shared audit is quite simply the only realistic way to increase the experience of firms outside the Big Four that do not currently have a presence in the reference market, or have only a small presence. As we have stated above, we do not believe that mandatory rotation will increase visibility of non Big Four firms' capabilities in any meaningful way and neither will mandatory tendering unless the involvement of non Big Four firms is mandated. Even then, tendering will increase *visibility* but unlike shared audit will not increase *experience or capacity*. We would urge the Commission to reconsider this option when making final deliberations if it does genuinely want to make a difference to this market and to refer to our previous submissions in this area where we have explored this option in more detail.

9. What combinations of remedy options would be particularly effective?

As should be evident from our comments in the remainder of this letter, our view is that mandatory tendering (with involvement of firms outside the Big Four mandated) together with mandatory shared audit provides the best combination of increased visibility of the capabilities of firms outside the Big Four together with increased practical experience of the reference market. We also believe (and have commented previously) that a robust limitation of liability mechanism, proportionate to the degree of fault, is vital in addressing the risk of entering the market, particularly in the event of any expansion of the auditor's reporting responsibilities.

Many of the proposed remedies are likely to have the effect of increased costs for businesses with debatable benefits. In particular, mandatory rotation will in our view lead to the undesirable outcome of audit appointments actually rotating off mid tier firms and onto the Big Four and not being replaced with similar appointments. The reference market will then simply consist of audits rotating around the Big Four and whilst this may well increase competition for audits in this market among the Big Four it will in no way increase the number of firms participating actively in this market.

10. Do you have any views on the nature, scale and likelihood of any relevant customer benefits within the meaning of section 134(8) of the Act arising from the adverse effect on competition?

The main benefit arising from the market in its current form is that companies have the ability to choose the audit firm that is most appropriate for the nature of their business. We do not believe that mandatory tendering (with non Big Four involvement) would reduce this benefit as if audit firm rotation was not mandated companies would still be able to retain the incumbent if that firm best met their needs. Whilst mandatory shared audit would mean that companies had to choose a different audit firm for the audit of some components, the company would be able to retain their incumbent auditor for the audit of the parent company (and indeed much of the group) and would have a wide choice of audit firms to perform the audit of the relevant components. We do not

therefore believe that this remedy would restrict company choice over much and the benefits in terms of increasing the pool of audit firms with experience in the reference market would be significant.

Conclusion

We hope that our comments are useful to you and in particular would urge you to reconsider some of the proposed remedies and to reconsider shared audit as a potential remedy. This is an important opportunity for the market for larger listed companies in the United Kingdom to be re-shaped and for some of the inequalities and misperceptions in that market to be addressed; however this will not be achieved by measures such as mandatory rotation which will penalise both companies and their auditors unnecessarily for no real benefit in terms of increased competition in the market.

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

Yours faithfully

Kingston Smith LLP