

5 August 2013

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

Our ref: mjs/tp/0508

Dear Sirs

Statutory Audit Services Market Investigation: provisional decision on remedies

Following on from the publication of your provisional decision on remedies to address the lack of competition in the audit market for larger listed entities, we are pleased to respond to your request for comments.

We are pleased that the Commission has ultimately decided that mandatory audit rotation does not need to be introduced in the UK. As we have commented in previous submissions to the Inquiry, we were concerned that mandatory rotation would reduce, rather than increase, competition and that it was also an unnecessary restriction of choice. We are also pleased that the Commission did not decide that any further restrictions on non-audit services were required. We are also glad to see that on the whole the Commission's proposals appear proportionate and reasonable.

However, whilst we believe that the Commission's proposals may well increase competition *between* Big Four firms, we are not convinced that they will necessarily increase competition more widely. We are also disappointed that shared audit is not being considered as a remedy as we believe that this is the only measure that would actually allow firms that do not currently have a presence in the reference market to build experience; we also remain convinced that a workable liability limitation mechanism, proportionate to the degree of fault, is necessary in order for the risks to firms of entering the reference market to be appropriately mitigated and not outweigh the benefits.

We have commented on the proposals in more detail below.

Requirement to tender the audit engagement every five years

As we have commented in our previous correspondence, we are in favour of mandatory tendering for companies in the reference market and of course the Financial Reporting Council has already introduced tendering on a comply or explain basis every ten years.

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The remedy is expressed in the summary as 'FTSE companies should put their statutory audit engagement out to tender at least every five years'. It appears from the detailed provisional decision that this equates to mandatory tendering every five years with no option to comply or explain, merely to defer tendering for two years in exceptional circumstances. This is clearly a tougher proposition than the 'comply or explain' tendering brought in by the FRC and is in some ways welcome, but we do have some concerns about its application in practice.

Firstly, we are concerned that requiring tendering every five years, rather than ten, will lead to excessive costs for businesses and indeed for audit firms as a full audit tender is a lengthy and costly process. In our view ten years, or two partner rotation cycles, would be sufficient and would be less disruptive.

Secondly – and most importantly in our view – we have our doubts as to whether the proposal, as drafted, will increase competition outside the Big Four in any meaningful way. In our previous comment letters we have proposed that the inclusion of at least one non Big Four firm in invitations to tender should be required, on a comply or explain basis to allow for exceptional circumstances (for instance the audits of systemic financial institutions). This does not appear to have been considered in detail by the Commission.

Without this requirement, we believe that in many cases invitations to tender will be limited to Big Four firms, given the widespread misperceptions among some (although we accept not all) businesses and institutional investors that 'only a Big Four firm will do'. Therefore, although on balance we think that this measure may well lead to more frequent changes in audit appointment we believe that in the majority of cases this will simply lead to one Big Four firm being exchanged for another with non Big Four firms continuing not to be invited to tender, due to misperceptions about the capabilities of mid tier firms. As we have commented previously, this concern appears to be borne out by the case studies you have published and the surveys you have undertaken in the reference market.

If inclusion of at least one non Big Four firm in invitations to tender was required, then this would give the mid tier firms a genuine opportunity to demonstrate their competence and abilities to companies in the reference market. Without this measure, although it is certainly possible that mid tier firms (particularly the larger ones) may undertake the necessary investment to compete in the reference market, there is less prospect of success. As we have commented previously, firms are unlikely to increase resource and headcount 'on spec' if they do not believe that genuine opportunities to participate in larger audits will be available to them as a result.

Expanded AQR reviews

We have a number of concerns about how this proposal would work in practice and there are some practical issues which would need to be addressed, not least that it would mean significantly increasing the size of the AQR team within the FRC (as the Commission recognises).

Subject to the FRC being able to increase its funding and therefore its workload, we have no particular objection to requiring each audit within the reference market to be reviewed by the AQR on average every five years. The content of the proposed report by the Audit Committee to shareholders would need to be carefully considered. We also believe that there is a need for AQR reporting to be more balanced and constructive rather than necessarily just focusing on the negatives if it is truly to be helpful in promoting competition.

With regards to the requirement to report on the 'larger mid tier firms' on an annual basis, we note that this means those which are subject to full AQR monitoring. We have some concerns about the

burden this will place on firms, but accept that this proposal would place such firms on a level playing field with the Big Four in terms of receiving an annual, rather than periodic, report and therefore any misperception that less frequent reporting means a lesser degree of audit quality would potentially be addressed.

We have also commented previously (as you noted in your detailed findings) that at present the AQR appears to be drawn largely from Big Four alumni and if the scope of AQR reviews is to be widened and it is genuinely to have any effect on competition, then its composition also needs to be addressed to ensure a better representation of the mid tier.

Prohibition of 'Big Four Only' clauses

We have always supported the prohibition of auditor choice restriction clauses and are pleased that the Commission has proposed this. However, as we have noted previously, this needs to encompass not just loan agreements but any document which might contain such a clause.

Advisory vote on sufficiency of disclosures in Audit Committee report

We have no particular objection to this proposal although we are not clear why it would have any significant effect on competition.

Accountability of auditor to the Audit Committee

Although we did not believe there was any particular need to require that only the Audit Committee can agree audit fees, make recommendations for the auditor's appointment and approve non-audit services, we do believe that this is a better way of addressing misperceptions of independence issues than (for instance) mandatory rotation would have been and therefore we have no particular objection to this proposal. However, as noted in previous correspondence, we do not believe it will have any significant effect on competition – other than, perhaps, within the Big Four – 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 serve on audit committees of companies in that market.

Financial Reporting Council to have due regard to competition

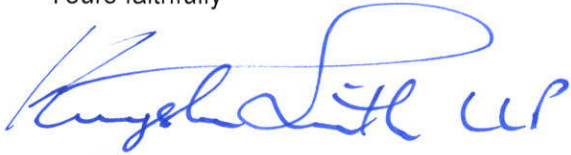
We are a little surprised that this proposed remedy is being pursued by the Commission following the FRC's own comments against the proposal (although we note that the proposal is now that the FRC 'have due regard to competition' rather than a duty to promote it). As noted in our comment letter dated 10 June 2013, we have some reservations as to how this might work in practice, not least given the current composition of the FRC. In the event this remedy is pursued then there will be various issues to consider not least how any duty to have regard to competition will fit in with the FRC's wider responsibilities.

Conclusion

Whilst we are supportive of the Commission's aims in proposing the above remedies, we remain sceptical that any genuine increase in competition will result. Although these measures may well increase the number and frequency of auditor changes, the lack of any requirement to include mid tier firms in the tender process is likely to mean that for many tenders only the Big Four will be asked to participate, due to the widespread misperceptions in the reference market. We would therefore urge the Commission to reconsider requiring inclusion of mid tier firms in invitations to tender, on a comply or explain basis.

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